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COMMISSION STAFF WORKING DOCUMENT

2024 Report on the euro area

Accompanying the document

Recommendation for a COUNCIL RECOMMENDATION

on the economic policy of the euro area

{COM(2023) 903 final}

Euro Area

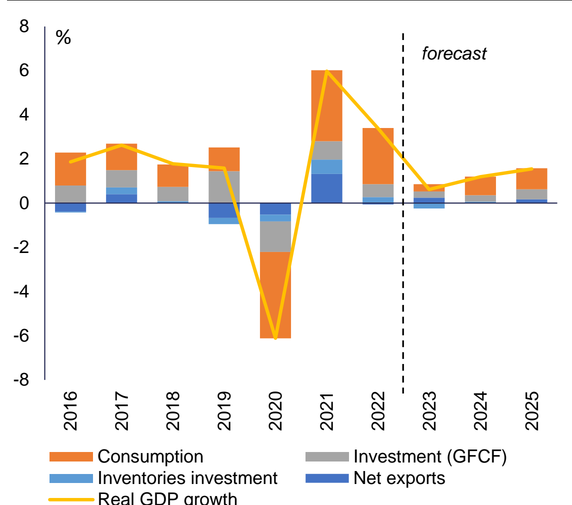
2024 Report

1. MACROECONOMIC OUTLOOK

Macroeconomic developments

After a continued rebound in 2022, the euro-area economy witnessed a strong deceleration this year. In 2022, the growth boost resulting from the post-COVID re-opening of the economy, together with policy support, led to a solid 3.4% economic expansion. Despite the rapid rise in energy prices in the winter of 2022, the euro area avoided a recession. The robust labour market has been and remains a key element of macroeconomic resilience and supportive of aggregate demand. Still, high consumer prices and tightening financing conditions have resulted in a loss of growth momentum over the course of 2023. For 2023, GDP for the euro area is expected to grow by 0.6%, with some Member States recording negative growth for the year as a whole.

Graph 1.1: **Real GDP growth and contributions, euro area**



(1) data for EA20 if not indicated otherwise
Source: European Commission

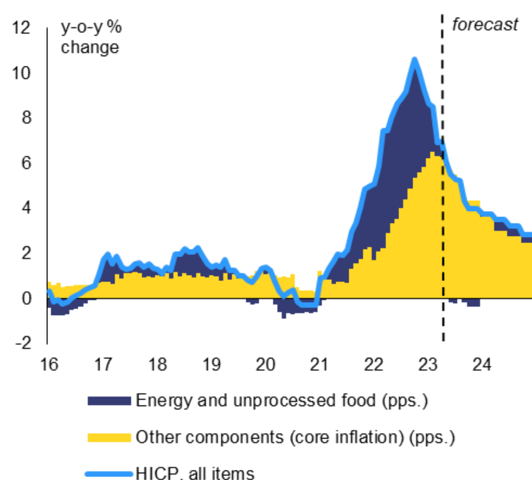
A mild rebound in growth is expected due to easing of inflation and a strong labour market. Entering 2024, the still high inflation and tighter financial conditions are set to weigh on economic activity. Rising nominal wages would only gradually lift real disposable incomes, in turn supporting a mild rebound in consumer spending. Recent survey results for the euro area point to weak economic activity, with continued weakness in industry and fading momentum in services, with, however, certain marginal improvements expected in the months ahead ([1]). With exports projected to grow at a moderate pace due to the more challenging global environment, the growth is set to be driven mostly by domestic demand. Overall, the GDP for the euro area is expected to grow by 1.2% in 2024 and by 1.6% in 2025 **(Graph 1.1)**.

Energy prices have gone down, while inflation excluding energy and food remains high though falling gradually. Euro area headline inflation fell sharply in October, to 2.9%. This is down from 4.3% in September, and as much as 7.7 pps from the peak recorded in October 2022. The decline was driven primarily by falling energy prices, but also by a gradual broad-based moderation in the other components. Lower energy and commodity prices, together with easing bottlenecks in the supply chains enabled non-energy prices to also fall. Yet, food inflation, although consistently declining, remains elevated. Services inflation also decelerated, but at a slower pace compared to other components (to 4.6% in October, after an increase to 5.6% in July), against the backdrop of wage growth, increasing unit profits **(see Box 3.1)** and persistently strong demand for contact-intensive services and tourism. The tightening monetary policy and contractionary fiscal policies helped ease inflationary pressures (see Section 2). Overall, headline inflation is projected to decline in the euro

([1]) European Commission, Business and consumer survey results, October 2023

area from 8.4% in 2022 to 5.6% in 2023, and then further down to 3.2% in 2024 and 2.2% in 2025. Core inflation ([2]) is expected to be slightly more persistent, however, increasing to 5.1% in 2023 from 4.0% in 2022, and then subsequently falling to 3.2% in 2024 and 2.5% in 2025. **(Graph 1.2)**

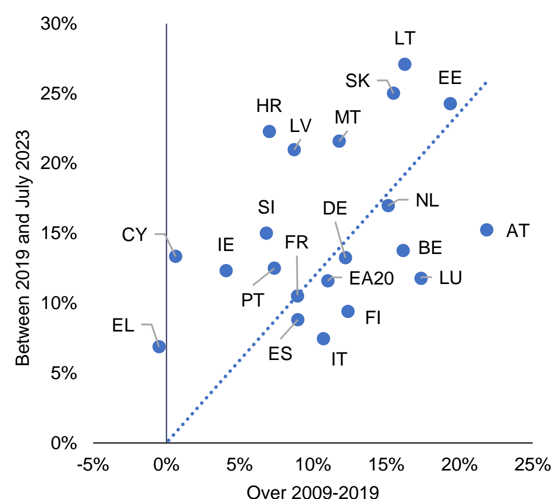
Graph 1.2: **Inflation breakdown, euro area**



Source: European Commission

The decrease in energy prices over 2023 has partly reduced the differences in inflation rates between the euro-area countries. In 2022, the inflation dispersion in the euro area was largely driven by differences in energy inflation, reflecting difference in the energy mix and in the sources of imported energy, as well as support measures implemented in the various Member States. Energy prices are expected to decrease in 2023 for most Member States, with the strongest decrease in the Member States that faced the sharpest increases in 2022, notably the Netherlands, Estonia and Belgium. However, the correction in energy prices remains far from complete, with some countries set to continue recording positive energy inflation. Moreover, inflation excluding food and energy remained high in most Member States in 2023, due in particular to the lagging effect of high energy prices. In the euro area, the core inflation recorded since 2019 is comparable to the cumulated increase in prices over the previous 10 years **(Graph 1.3)**. In a number of countries, including the Baltics, Croatia and Slovakia, the shock is even stronger.

Graph 1.3: **Convergence of underlying inflation, euro area**



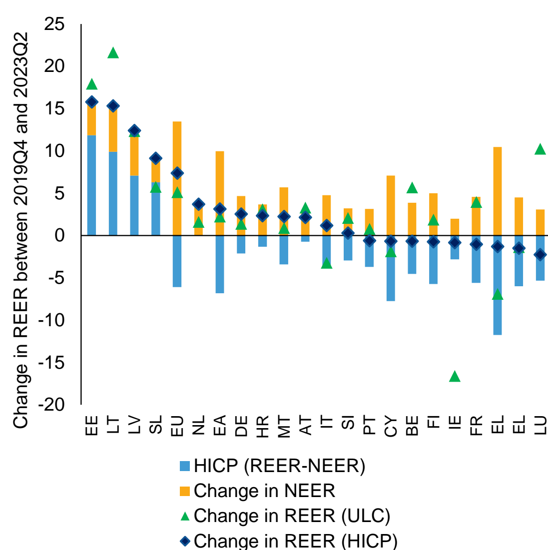
(1) HICP inflation excluding food and energy
(2) 2019 - 2023 cumulated inflation compared to 2009 - 2019 cumulated inflation
Source: Eurostat, own calculations

The labour market is close to full employment, and wage growth is gradually restoring purchasing power. Over the last two years, unemployment rates throughout the euro area have stabilised at record low levels, standing at 6.5% in September, down from 6.7% in the same period of the previous year. Meanwhile, employment continues to increase in almost of the Member States, except Italy, Latvia, Croatia and Estonia, recording from modest to moderate contraction of their employment rates in Q2 2023. Employment growth is particularly strong in low energy-dependent sectors, notably some services (See Section 3). Despite the slowdown in activity in the first part of 2023, the labour market remains very tight, with euro-area job vacancy rate remaining at elevated levels (3% in Q2 2023). In that context, wages have so far not kept pace with inflation, which is likely due to a lagged wage bargaining. In 2023, there are early signs of wage acceleration (see Section 2), although real wages are only expected to rebound as of the end of 2023 and recover moderately in the course of 2024.

([2]) Core inflation is defined in this report as overall HICP inflation excluding energy, food, alcohol and tobacco.

The euro real effective exchange rate has appreciated in 2023 denting cost competitiveness. In 2019 - 2022, the depreciation in the value of euro compared to the currencies of the main trading partners supported the euro area cost-competitiveness. Since then, the increase in inflation, together with an appreciation in the euro against other currencies, has led to a deterioration in overall cost competitiveness. Within the euro area, divergences in price dynamics have led to a deterioration in the relative competitiveness of some Member States, notably the Baltics and Slovakia **(Graph 1.4)**, although some rebalancing could also be observed (see Section 5).

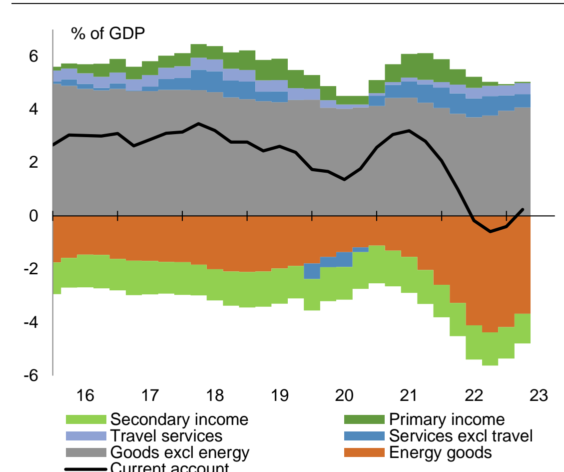
Graph 1.4: **Decomposition of the change in the real effective exchange rate (December 2019-June 2023)**



Source: Eurostat, own calculations

After a sharp fall in 2022, current account balances have rebounded, easing concerns about short term risks. The strong deterioration in the euro area's energy balance led to a sizeable negative terms of trade shock, which resulted in a sharp reduction in the euro area's current account surplus in 2022. In countries that had already recorded a deficit, the drop in current account balances created concerns about possible imbalances. As the energy shock gradually dissipates, the euro-area current account bottomed out in the first quarter of 2023 **(Graph 1.5)**, although with significant differences between Member States. In several countries, the deterioration in the energy balance was counterbalanced by a solid performance in services, particularly travel services (Spain and France). This helped somewhat reduce current account imbalances across the euro area. The euro-area current account balance is expected to increase in the next years, although it is set to remain below pre-pandemics levels. In addition, differences in cost competitiveness between Member States may be a cause for concern, as they may lead to emergence of new vulnerabilities (European Commission, 2023a).

Graph 1.5: **Current account composition, euro area**



(1) Four-quarter moving sum
Source: European Commission

The economic outlook continues to be marked by major risks linked in particular to geopolitical tensions. Measures to diversify energy sources and reduce energy demand are supporting higher resilience of the euro area. Still, geopolitical tensions will continue to keep energy prices high in the medium term. Persistence of high non-food and energy inflation is a key emerging risk. In particular, the euro area faces uncertainty, as to whether wages can be adjusted to recoup losses in the purchasing power without driving up inflation. The risks of higher-than-expected inflation therefore remain strong. This, in turn, would result in stronger monetary reaction that would adversely impact growth.

In the longer term, the euro area economy faces significant structural

challenges. The changing global geopolitical landscape entails long-term risks of persistent trade fragmentation and divergences in economic policies of global actors and key trade partners of the euro area **(see Box 5.1)**. In addition, the demographic outlook for the euro area is that of a shrinking and ageing population ([3]). This entails long-term limitations in potential growth and risks for the sustainability of public finances, in particular against the backdrop of persistently slow productivity growth and lack of innovation in the euro area. Moreover, the intensifying impact of climate change, as illustrated by the extreme weather conditions and unprecedented wildfires and floods in the summer, is set to weigh on economic growth. It also calls on decisive actions to accelerate the green transition and reach climate objectives.

Policy implications

Weaker growth in 2023 combined with persistent inflationary pressures underscore the importance of continued consistency between monetary and fiscal policy. To bring down inflation, the European Central Bank (ECB) has decided on a series of hikes bringing policy interest rates to high levels. While the ECB has decided to pause the increase in policy rates in October, it has repeatedly committed to setting them as high as needed for "as long as necessary". Meanwhile, fiscal policy coordination is key to helping monetary policy bring inflation back to its medium-term target in a timely manner. Member States should adopt coordinated and prudent fiscal policies to keep debt at prudent levels or put debt ratios on a plausibly downward path. While remaining agile in view of the high uncertainty, achieving a contractionary fiscal stance, as expected in 2023 and 2024, will contribute to restoring fiscal buffers over time and thus to improving the sustainability of public debt in some Member States. Besides the need to maintain a prudent fiscal strategy, public investment needs to be maintained and, where needed increased, to support long-term growth and the green transition.

The labour market has proven resilient so far and wages have reacted moderately to the inflation surge but are expected to accelerate. The post-COVID 19 period has been marked by very high employment and decreasing unemployment. The strong labour demand, together with factors limiting labour supply, have resulted into labour shortages that are widespread across occupations and skill levels. Measures to increase the labour force, in particular through active labour market policies, are helpful in that respect. Despite the tight labour market, wages increased less than inflation in 2022 and 2023, leading to an increase in unit profits and to decreasing purchasing power for workers. In countries with indexation mechanisms, in particular for minimum wages, social consequences on low-paid workers have been more limited. Going forward, real wages are expected to recover part of the past losses and a fine balance needs to be struck between regaining the lost purchasing power for workers, limiting second-round effects of wages on inflation, and avoiding sustained competitiveness losses in some countries.

The tightening of monetary policy calls for a careful monitoring of risks in the financial sector. The rapid increase in interest rates and the accompanying tightening of financial conditions throughout the euro area have put a lid on credit growth. Slower economic growth and higher interest rates have affected the housing market, especially in countries where prices were over-valued and where household debt is high (European Commission, 2023a). Several Member States recorded a fall in real estate prices in 2023, with impact on households' wealth and commercial real estate companies. Progress made by euro-area banks in strengthening their balance sheet has increased their resilience and generally equipped them well to respond to a potential deterioration in asset quality. Meanwhile, the risks may emerge regarding non-bank financial intermediaries (e.g., insurers and

([3]) The euro area population is expected to decrease by 4.5% between 2022 and 2100.

investment funds), which are less regulated, and on which less information is available. Risk may also build up due to potential further asset price corrections, volatile markets, and a turning real estate cycle.

High energy costs and inflation, together with geopolitical developments, underline the need to support the euro area's competitiveness. The durably higher energy costs in the euro area compared to global partners together with the increasing labour costs risks leading to a deterioration in the cost competitiveness of euro-area economies. These shocks have already undermined the trade performance of energy-intensive sectors. Differences in price levels between euro-area countries, including for non-energy goods, have so far not been alleviated by the decrease in energy prices. This is leading to a deterioration of the relative competitiveness of some countries vis-à-vis euro area peers. Such an uneven impact across the euro area, if sustained, may also feed macroeconomic imbalances (European Commission 2023a). In the long-term, the euro area's competitiveness will be determined by its ability to increase productivity, in particular through increasing skills and innovation. Supporting investment, both public and private, also remains a policy priority. Accordingly, the timely implementation of the investment and reforms set out in the national recovery and resilience plans and cohesion policy programmes can spur productivity and growth. Improving the business environment is also critical to boost investment and competitiveness in the private sector. Specifically, making further progress in the Capital Market Union would help innovative companies access to the different forms of finance for their investments.

POLICY CHALLENGES RELATED TO HIGH INFLATION

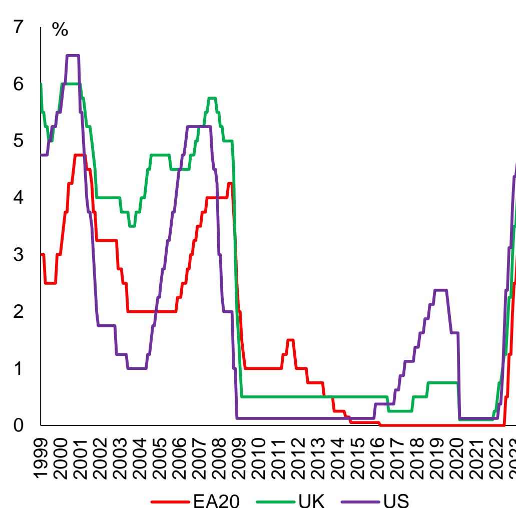
2. FISCAL AND MONETARY POLICY MIX

Persistently high inflation dynamics continue to require fiscal and monetary policy to work in tandem. After the highly supportive fiscal and monetary stances adopted during the COVID-19 crisis, the rise in inflation prompted a shift in policy. As the ECB embarks on the fastest-ever tightening of its monetary stance, fiscal policies have a role to play, steering away from an expansionary stance that could feed inflation, including by rolling back energy support measures. For some Member States, the need for a tighter fiscal stance is also reinforced by the high debt and deficit ratios. At the same time, there is a need for public authorities to continue support to the cost of living for the most vulnerable part of the population.

Monetary policy

The ECB has responded to the high inflation shock with the fastest-ever increase in policy rates since the creation of the monetary union. In 2021, inflation started to rise from a very low level on the back of COVID-19-related demand and supply mismatches and accelerated sharply in the wake of Russia's aggression against Ukraine. Starting in July 2022, the ECB increased its policy rates by a total of 450 basis points over 15 months **(Graph 2.1)**. Although current rates are close to historical highs, the hikes since June 2022 have been larger and faster than in past cycles. The ECB also brought its net asset purchases to an end. In March 2022, the ECB discontinued net asset purchases under the Pandemic Emergency Purchase Programme (PEPP), and those under the Asset Purchase Programme (APP) were concluded in June 2022 ([4]). As inflationary pressures, as gauged by core inflation, remain high, the ECB monetary policy is expected to remain restrictive in order to achieve a return of inflation to the 2 % target. At the same time, the ECB has clarified that the future monetary policy path will be data-dependent.

Graph 2.1: **Central banks' key policy rates in the euro area compared to the UK and the US**



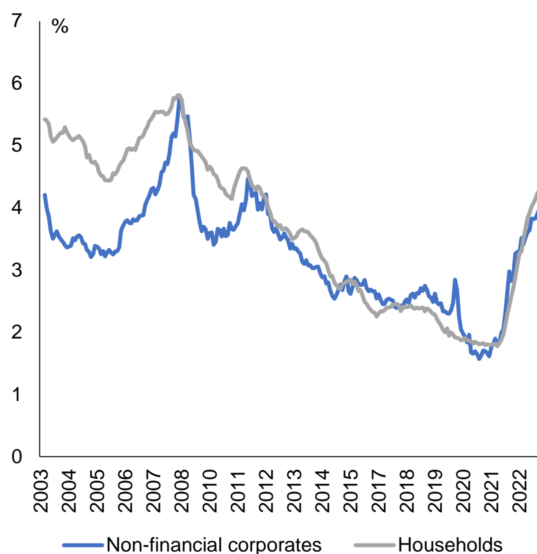
Source: Bank of International Settlements

The increases in policy rates have led to tightening financial conditions. The Commission's composite cost-of-borrowing indicators for non-financial corporations (NFCs) and households, which combines interest rates on all loans to corporations and all loans to households, started to increase in 2022, driven by significant increases in interest rates **(Graph 2.2)**. The tightening in financial conditions led to a drop in lending activities and, in particular, in housing loans, slowing down economic activity by affecting investments. Given the lags in the transmission of monetary policy, it is still challenging to determine the full impact. Model-driven assessments have estimated

([4]) The reinvesting of the proceedings of maturing securities purchased under the APP was also stopped one year later, while reinvestments under PEPP are set to continue until the end of 2024.

that the euro area's real GDP growth could face a noticeable reduction due to monetary policy tightening, with an average decrease of about 2 ppt annually from 2022 to 2025 (Darracq Pariès et al., 2023).

Graph 2.2: **Cost of borrowing indicators**



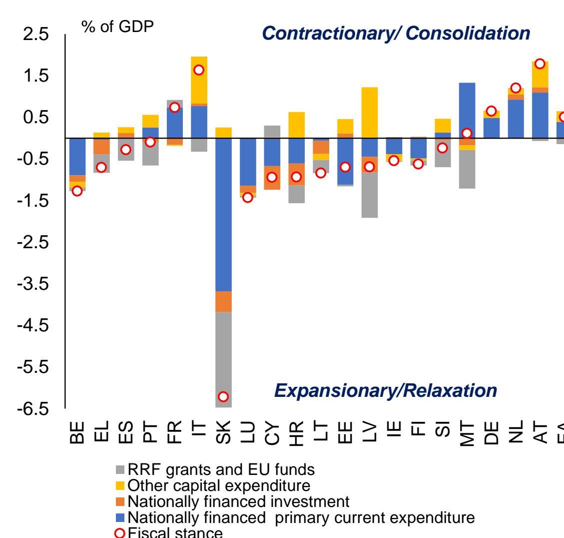
Source: European Commission

Sovereign spreads in the euro area have remained stable so far. By the end of 2021, in line with the expectations on the path of policy rates, 10-year government bond yields started to increase. In September 2023, government yields in euro area countries ranged between 2.5 % and 4.2 %, compared to a range of -0.4 % and 1.3 % in December 2021, thus implying a level shift of about 3 ppt. Overall, the transmission of rate hikes to sovereign bond markets since the start of the hiking cycle has not translated into an excessive widening of sovereign spreads. On the other hand, statistics on lending activities show some heterogeneity (see Section 4), suggesting that, in the longer term, the real impact of the monetary policy will differ across Member States.

FISCAL POLICY STANCE

The aggregate contractionary stance in 2023 supported the reduction in inflation. The euro area fiscal stance in 2023 is estimated to be contractionary, at ½% of GDP. Nationally financed net primary current expenditure has been reduced in 2023, largely due to the partial phase-out of energy-related measures, introduced in 2022, when they induced a sizable expansion. A reduction in government subsidies for private investment (other capital expenditure) also contributed to the contraction in 2023. Conversely, the expenditure financed by RRF grants and other EU funds is set to increase further, reducing the contractionary nature of the fiscal stance. This has supported investment, while public investment financed by national budgets has been preserved, making a neutral contribution. **(Graph 2.3).**

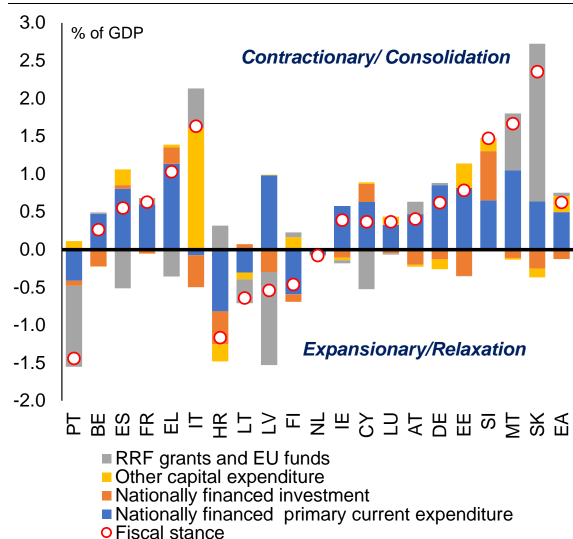
Graph 2.3: **Euro area fiscal stance in 2023**



Source: European Commission

In 2024, the fiscal stance is set to remain contractionary, with large heterogeneity across Member States. The Commission 2023 Autumn forecast indicates that the euro area fiscal stance would remain contractionary in 2024, by around ½% of GDP. There is a wide range across Member States, from a contractionary stance of more than 2% of GDP to an expansionary stance of 1.5%. Overall, the fiscal stance is expected to be contractionary or broadly neutral in most Member States **(Graph 2.4)**, while it is set to be expansionary in five Member States. A contractionary stance is projected in all high-debt Member States but Portugal.

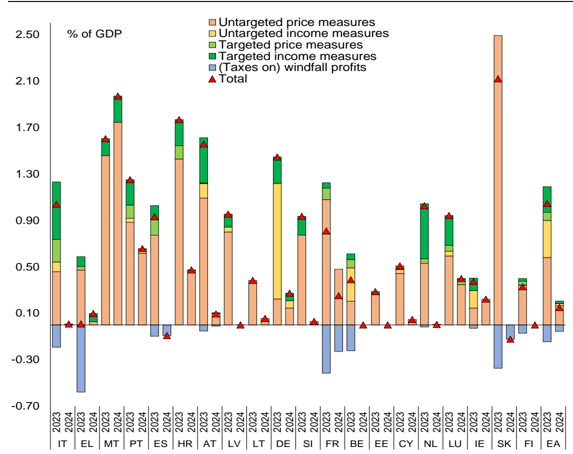
Graph 2.4: **Euro area fiscal stance in 2024**



Source: European Commission

Energy-crises related support measures, which remained sizeable in 2023 are expected to be almost completely phased out in 2024. Persistently elevated energy costs in 2023 have led many Member States to continue extending support to households and businesses. The Commission estimates that the total cost of such measures amounts to 1.0% of the euro area GDP in 2023, a slight decrease from 1.3% in 2022. Most of the measures are expected to be phased out in the next year, with a remaining budgetary cost of 0.2% of GDP in 2024 **(Graph 2.5)**.

Graph 2.5: **Budgetary cost of fiscal measures to mitigate the impact of energy price increases in 2023 and 2024**



Source: European Commission

IMPACT OF INFLATION ON PUBLIC FINANCES

The high inflation has an impact on public finances through both revenues and expenditures, with a strong impact of energy measures. On the revenue side, the favourable composition of economic activity, notably an increased share of consumption of goods, and the increase in prices in tax-intensive goods, in particular energy, resulted in sizeable windfall revenues last year. On the expenditure side, the price adjustment of social transfers, public wages and new public procurement will push nominal expenditures up over time. Meanwhile, the measures taken by Member States to support the economy in the face of high inflation had a strong impact on public finance developments. The lowering of VAT rates and excise duties on energy products reduced the revenue-to-GDP, and public subsidies, which have reached record levels during the COVID-19 crisis, remained high.

Going forward, the high inflation will lead to durable upward pressure on public expenditure. As the price adjustment of many public expenditure components occurs with a delay, the high inflation will continue exerting pressure on public expenditures in the coming years. In addition, after a decade of decreasing costs of debt financing, the interest expenditure-to-GDP ratio is expected to rise again. The average maturity of government debt in the euro area, which determines the speed of the transmission of higher interest rates to an actual increase in interest payments, is distributed around 8 years. In the medium-term, interest payments are thus set to weigh on public finances much more than what they did in the past, diverting resources from other priorities.

Public investment will continue growing, also supported by the RRF. In 2023, public investment in the euro area is expected to rise to 3.1% of GDP compared to 2.8% in 2019 and to further increase to 3.2% in 2024. This is consistent with the need to increase investment to support the green and digital

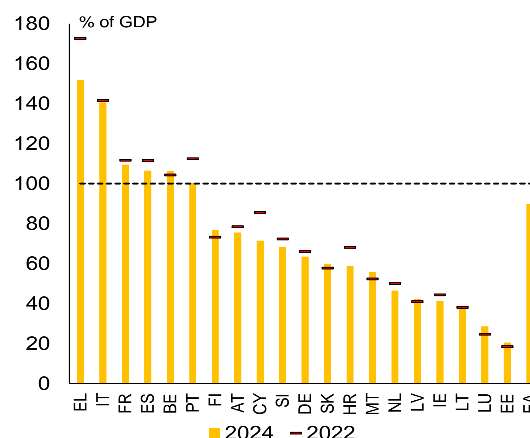
transition. In particular, around one-third of the projected increase between 2019 and 2024 is due to new investments financed by RRF grants.

In a context of reduced fiscal space, it is critical that investments represent value-for-money. Spending reviews can be useful tool to support fiscal policy objectives. By identifying and weighing efficiency gains and saving options, spending reviews can help free up fiscal space and reorient spending towards policy priorities ([5]). Spending reviews can also be usefully coupled to green budgeting practices to identify fiscal measures that are environmentally harmful. Cutting back on support to fossil fuel consumption and other environmentally harmful subsidies would yield significant budgetary gains and generate fiscal space. Aligning price incentives with climate neutrality, rewarding efforts to internalise environmental externalities and implementing the polluter pays principle are also key to create a level playing field for sustainable alternatives and to bolster the green transition.

DEBT DYNAMICS AND SUSTAINABILITY

The euro area public debt-to-GDP ratio is declining in 2023 and 2024, though from a high level. Over 2023 and 2024, the euro area debt-to GDP ratio is expected to decline by 2.8 pps., reaching 89.7% of GDP in 2024. Most euro area countries are expected to experience declining ratios, reflecting the effects of high inflation on nominal GDP (a favourable snowball effect). This effect is particularly strong in Member States with a high debt. Notably, between 2022 and 2024, public debt is predicted to decrease by around 21 pps. in Greece, by 14 pps. in Cyprus, and by 12 pps. in Portugal. Still, in 2024, six countries will continue to have debt ratios surpassing 100% of GDP, giving them limited fiscal space **(Graph 2.6)**.

Graph 2.6: **Public Debt to GDP ratio, 2024 vs 2022**



Source: European Commission

The debt projections for the upcoming years are subject to high uncertainty. Stochastic simulations, which apply a large range of macroeconomic shocks around the central scenario, suggest that euro area debt is likely to lie between 85% and 95% of GDP in 2024, and between 79% and 102% of GDP in 2028. Several factors weigh on fiscal sustainability. In particular, the less favourable macro-financial environment is expected to negatively affect public debt dynamics over the coming years. The increase in interest rates, notably prompted by heighted inflationary pressures, is progressively feeding into interest payments and the debt dynamics. Moreover, population ageing acts as a drag on potential growth, while increasing public spending. Against the background of uncertain growth prospects, also linked to the geopolitical environment, these risks point to the importance of implementing reforms and investment to relaunch growth potential and pursuing responsible fiscal policies. At the same time, other factors may mitigate fiscal sustainability risks. These factors include the lengthening of government debt maturities in recent years, stable financing sources and EU initiatives such as the Next Generation EU and the Recovery and Resilience Facility (RRF).

Fiscal sustainability, inclusive growth, and support to investment and reforms

([5]) Spending reviews yielded results in social security savings for 2022, for example allowing Spain to identify relevant saving options and Slovakia to potentially save up to 0.3% of GDP. See for example SK and ES Stability Programme 2023-2026.

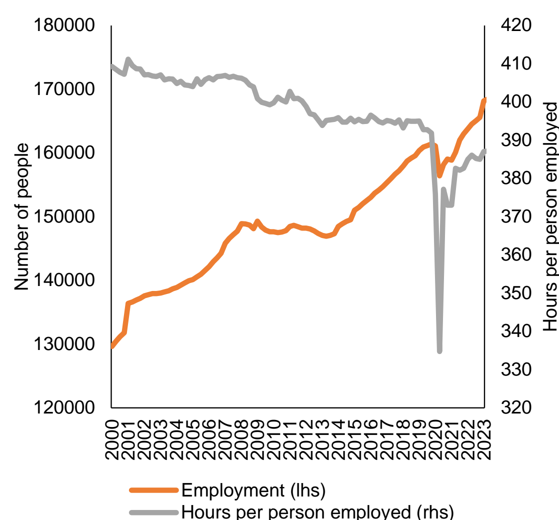
are the main objectives in the ongoing reform of the Economic Governance. With debt above the already elevated pre-pandemic levels and sustainability challenges remaining elevated and widespread across countries, a renewed emphasis on debt sustainability and economic growth is key. Given the challenging macroeconomic environment, Member States should adopt stable and credible debt reduction paths. The Commission's proposals for a reform of the Economic Governance Framework aim at promoting realistic, sustained and gradual fiscal adjustments guided by country-specific medium-term plans, while at the same time enhancing sustainable growth by incentivising reforms and investments.

3. WAGE DEVELOPMENTS AND DISTRIBUTIONAL IMPACT OF INFLATION

Labour markets developments

Labour markets in the euro area are performing well despite the slowdown in economic activity. Close to 170 million people were employed in the euro area in Q2 2023, the highest number ever **(Graph 3.1)**. Strong employment growth is supported by increasing labour supply. Despite an ageing population, the activity rate in the euro area returned to its long-term upward trend, after the temporary contraction during the pandemic. The unemployment rate stood at about 6.7% in 2022 and 6.5% in 2023 (until September) – the lowest rate recorded since the creation of the monetary union.

Graph 3.1: **Employment and hours worked in the euro area**



Source: Eurostat.

Average working hours have not fully recovered to pre-COVID levels, but resumed the steady downward trend. The number of working hours per person, which plummeted in 2020 due to confinement policies, recovered to a great extent to a level consistent with its long-run downward trend. A number of explanations are thought to explain this longer-term downward trend in average hours worked, including the rising importance of services characterised by a lower number of hours worked per worker. Additional factors keeping average hours below pre-2019 levels may include increased sick leave and labour hoarding by firms facing temporarily lower demand (Arce et al., 2023).

Recent developments are helping to bridge differences in labour market performance across the euro area. Compared to the pre-pandemic average, the drop in unemployment since 2022 has been greater in high-unemployment countries. The observed levelling up of unemployment rates across the euro area continues a trend observed before 2019, but may also have been reinforced by sectoral dynamics and the impact of the energy shock. More energy-intensive industries (e.g., manufacturing and transport), which performed well in the pre-crisis period recorded lower job creation [6] while low energy consumption sectors, and in particular services, performed better **(Graph 3.2)**. The energy price shock dampened employment growth primarily in high energy-intensive sectors.

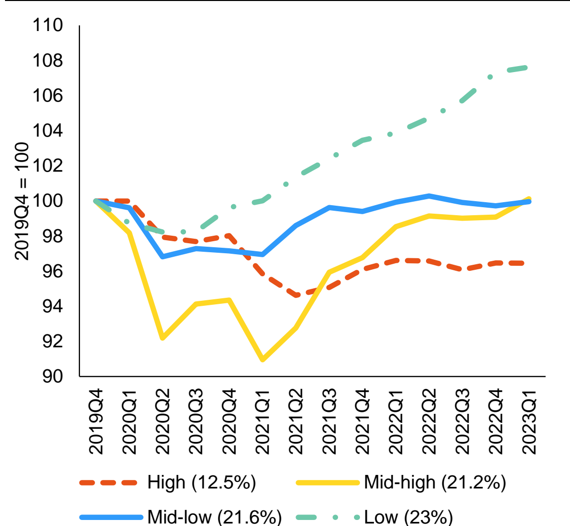
Labour and skill shortages are signs of a very tight labour market. In 2022 and early 2023 the euro area vacancy rate, i.e. the proportion of total jobs that are unoccupied or about to become vacant, hovered around 3% - the highest level since 2008. In July 2023, around 24.5% of firms reported labour as a factor limiting production [7] and 74% of SMEs

[6] For a more in-depth assessment of the impact of the energy price shock on employment see European Commission, 2023g.

[7] Compared to about 17% before the pandemic. Source: European Commission Business and Consumer Survey.

reported that they face skills shortages (Eurostat, 2023). Shortages are particularly strong in the services sector. Meanwhile, skill shortages have become major bottlenecks for some occupations, including ICT, construction, engineering and healthcare. Reducing skills shortages and mismatches, in particular by up- and re-skilling workers, can boost productivity and is essential to support the green and digital transition.

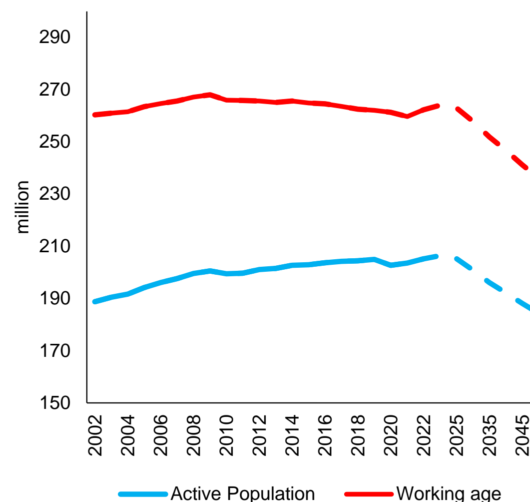
Graph 3.2: **Employment by industry according to the energy intensity of each industry (2019Q4=100)**



(1) Energy intensity is measured as Tera Joules per unit of value added. The different groups are defined classifying 55 sectors of the economy on the basis of the quartile of the sectorial distribution of energy intensity.
Source: Eurostat.

With a decreasing working age population, maintaining labour supply will remain a major long-term policy challenge. The working age population (20-64-year-olds) reached a peak of 272 million in 2009 **(Graph 3.3)**. It declined to 265 million in 2022 and is projected to continue falling to 258 million by 2030 ([8]). Population decline and ageing will cause GDP to decline in Member States to varying degrees. By 2030, demographic trends are expected to negatively affect the level of GDP in most euro area members, ranging from 0.2% in the Netherlands to 7.6% in Italy (European Commission, 2023b).

Graph 3.3: **Working age population and activity in the coming decades**



Source: EU Commission services based on Eurostat and OECD data and EUROPOP2023 population projections.

Policies to support labour supply can help address labour and skill shortages. Active labour market policies play a key role in boosting employment and labour force participation especially in groups with relative high inactivity (e.g., women and youth, particularly with migrant background) and easing the transition of workers and jobseekers in the labour market. Managed legal migration in shortage occupations could also help addressing labour and skill shortages, especially by targeting bottleneck occupations. Activating people of working age, in particular women, young and older people and people with migrant background; improving access to childcare and long-term care; reducing skills shortages: improving working conditions in certain sectors; and intra-EU mobility are vital for mitigating labour shortages in the euro area, but it will not suffice to meet needs in all shortage occupations (European Commission, 2023c). In complement to policies harnessing talents within the EU, including non-EU citizens already legally residing in the EU, legal migration from non-EU countries can help employers fill vacancies at all skills levels, including for occupations with a critical role for the EU economy and its green and digital

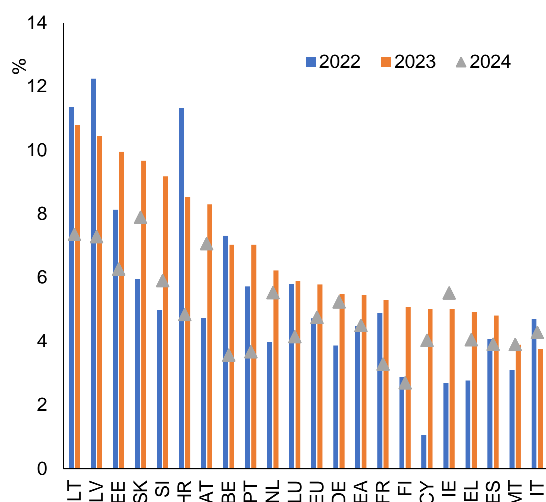
([8]) Eurostat's 2023 population projection.

transition in the context of the Green Deal Industrial Plan. Given the size of its labour market, labour migration to the euro area remains low in international comparison (European Commission, 2023d).

Wage developments

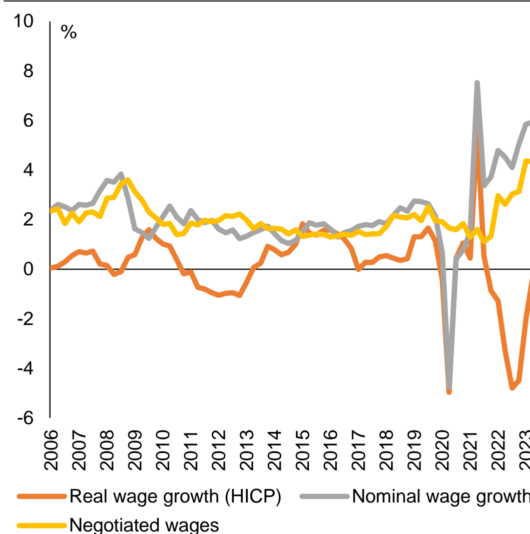
Increase in nominal wages are helping households to gradually recover purchasing power. In the euro area, nominal compensation per employee increased by 4.3% in 2022 **(Graph 3.4)** and by 5.4% in Q1 2023 (y-o-y), a record high for most Member States. However, in real terms, wages decreased by 3.5% in 2022 **(Graph 3.5)**, amid growing concerns for the adverse social consequences of purchasing power losses, especially for low-wage earners. Looking ahead, while nominal wage growth is likely to further increase over the next quarters, real wages are set to only increase from Q3 2023 onwards (European Commission, 2023e).

Graph 3.4: **Nominal compensation per employee (2022-24)**



Source: AMECO and Autumn 2023 Forecast.

Graph 3.5: **Nominal and real compensation for employee (y-o-y changes)**



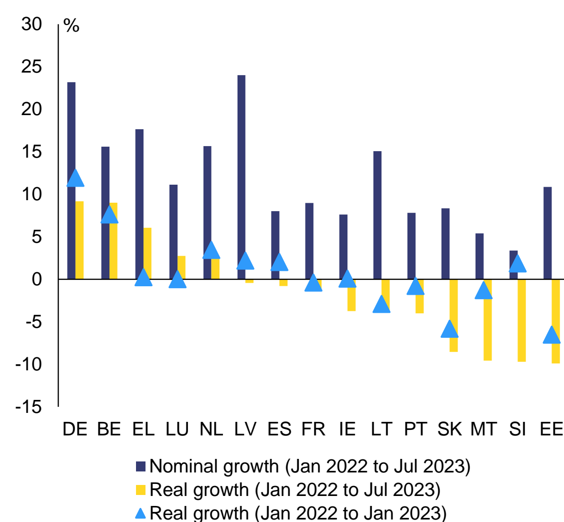
Source: Real wages are computed using the HICP index as deflator.

Increases in statutory minimum wages have partly mitigated the impact of high inflation on low-wage earners. Statutory minimum wages rose by more than 5% in nominal terms in all Member States in 2022 where such wages are in place, and even by more than 10% in around half of these countries **(Graph 3.6)**. Such increases in statutory minimum wages were the result of substantial increases throughout 2022, the January 2023 updates ([9]) and some updates in a few Member States after January 2023. They have largely compensated the impact of high inflation on the purchasing power of minimum wage earners in half of Member States with statutory minimum wages. The increases in 2022 reflected automatic indexation adjustments where such a mechanism is in place (e.g., Belgium, France or Luxembourg), as well as discretionary updates (e.g., Germany, Greece and the Netherlands) (Eurofound, 2023). Given the tight labour market, these increases have had no impact on minimum wage employment. However, they have resulted in a compression

([9]) Minimum wages are often updated annually, at the beginning of the year. In January 2023, the largest increases were registered in Latvia, with an increase of 24%, and in Romania, Hungary, Poland, Lithuania, Croatia, Slovenia, Estonia, and the Netherlands, with increases between 10% and 20%.

of the wage scale which may put pressure on collective bargaining going forward.

Graph 3.6: **Minimum wage in Member States with statutory minimum wages**



(1) CY excluded as the statutory minimum wage was introduced in 2022. Real wages are computed using the HICP index as deflator.
Source: Eurofound.

Real wages are expected to recover gradually. Collective wage contracts are multi-year and staggered, implying an expectation for the ongoing wage acceleration to persist. This may in turn underpin the dynamics of inflation for some time. In addition, since end-2022, core goods and services have replaced energy and unprocessed food as the primary driver of headline inflation in the euro area (ECB, 2023a).

The increase in corporate profit leaves scope for adjustment in real wages in the concerned sectors with limited second-round effects on inflation. A fine balance needs to be struck between regaining the lost purchasing power for workers, especially those with low incomes, limiting second-round effects of wages on inflation, and avoiding competitiveness losses. As real wages recover, wage dynamics will increasingly contribute to domestic inflation. In particular, the dynamics of inflation will crucially depend on the way unit labour costs and unit profits interact **(Box 3.1)** [10]. After their strong increase in recent years, unit profits are expected to decline in the course of 2023 and beyond providing a buffer for the increase in nominal wages and mitigating pressures on consumer prices. To the extent that wage setting across the euro area and the EU, in particular for new contracts, reflect an expectation that inflation will normalise over the medium-term, having a moderate impact on wage growth [11].

Social implications

The strong labour market and supporting policy measures have mitigated the impact of inflation on households' real disposable income. Household income declined by about 0.7% in the year ending in Q4 2022 **(Graph 3.7)**. Rising inflation which led to falls in the real compensation of employees and of the self-employed, and to falls in (net) social benefits. Policy measures – income measures or price measures -- mitigated the impact of high inflation and cushioned the drop in real disposable incomes. In Q1 2023, household incomes have rebounded in real terms (+0.5 %) as the decline in real wages was balanced by lower taxes, higher benefits and other transfers (European Commission, 2023e). A number of social indicators, including the number of people at risk of poverty or social exclusion, remained stable in 2022, reflecting the resilience of the labour market and the support mechanisms.

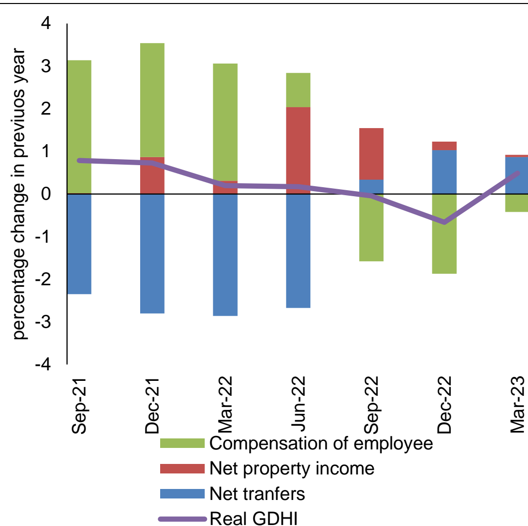
The rise in the cost of living had particularly strong impact on vulnerable groups. As low-income households spend a higher share of their income on food and

(10) In absence of a decline in the profit share, any wage increases beyond productivity gains will lead to higher inflation, increasing the risk of loosening inflation expectations and ultimately forcing the central banks to tighten monetary policy more than otherwise would be the case. See also Arce et al. (2023).

(11) Ex-post inflation indexation plays a relevant role only in a handful of countries (Belgium, Cyprus, Luxembourg, Malta).

energy, people at the bottom of the income distribution have experienced a higher increase in the cost of living than those at the top (1.7 pps higher on average). The gap varies considerably across countries – the widest gap is recorded in Latvia, where low-income households face an inflation rate almost 4pps higher than medium income ones (Caisl et al., 2023). Inflationary pressures were also stronger for older people and those living in rural areas due to their lower ability to adjust consumption. Because of the unequal impact on population groups, the financial distress among households in the lowest income quartile at EU level rose from 22.0% in July 2021 to 29.1% in September 2023, with the largest increases observed in Estonia (from 1% to 30%).

Graph 3.7: **Real gross disposable household income growth and its main components**

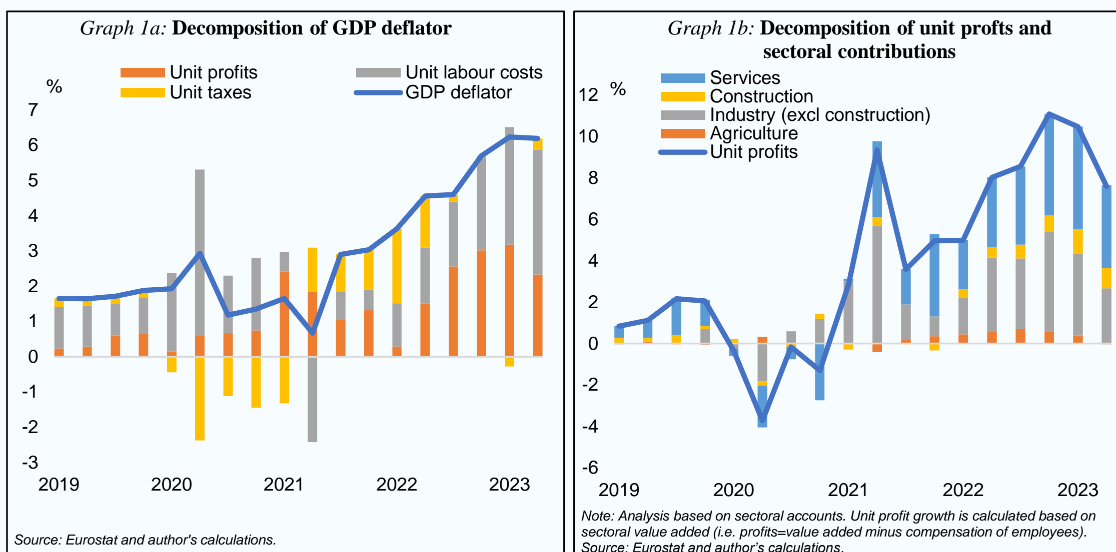


(1) GDHI, gross disposable household income in the EA20. The nominal GDHI is converted into real GDHI by deflating values using the deflator (price index) of household final consumption expenditure. Net transfers notably include net social benefits and taxes on income and wealth (negative contributions).
Source: Commission calculations based on Eurostat, National Accounts.

Although generally poorly targeted, energy measures effectively supported households. More than half of the energy support measures implemented by Member States consisted in price measures, which aim at reducing energy prices. Such measure were poorly targeted towards vulnerable households. While they do contribute to reduce inequality in real wages and in welfare, they do it at a much higher cost than more targeted income measures. Altogether, the measures implemented were able to mitigate, and in several Member States fully offset, the negative impact of higher energy price on real wage and welfare equality across income deciles (Amores et al., 2023).

Box 3.1: The increase in unit profits is a temporary phenomenon reflecting high inflation

High inflation has put the distribution of value added between profit, compensation of employees and taxes under the spotlight. A number of empirical studies ([1]) have highlighted the increase in unit profits that has accompanied the increase in inflation in 2022. Based on a decomposition of the GDP deflator, unit profits appear to have increased steadily in 2022, growing at a record 9.3% (year-on-year) in Q1 2023 before decreasing slightly in Q2 (**Graph 1a**). ([2]) Unit profits have increased across all euro area countries and sectors, albeit with wide variations. In 2021, the increase in unit profit was led by industry, including manufacturing, energy and utilities, as well as mining, but other sectors, including services, caught up in 2022 (**Graph 1b**). The mirror image of the rise in profit has been a lower share of value added going to labour income. Accordingly, concerns that the rise in inflation may translate into extraordinary profits in some sectors, to the detriment of workers, led some European governments to take policy action. A number of Member States announced windfall taxes on sectors including banks (e.g. Spain and Italy) and food distributors (in Portugal).



Source: Eurostat and author's calculations.

Note: Analysis based on sectoral accounts. Unit profit growth is calculated based on sectoral value added (i.e. profits=value added minus compensation of employees).
Source: Eurostat and author's calculations.

A higher inflation does not point to weak competition, nor does a higher level of competition necessarily translate in lower inflation. In fact, in the short run, the relationship between competition and inflation depends on the nature of the shock. An increase in input costs will typically result in higher inflation in more competitive environments, as firms cannot absorb costs inflation through lower margin (OECD, 2022). Second, market power affects the absolute price level rather than the price changes. Still, in a high-cost inflation environment, consumers may have more understanding for a firm increasing its prices and are less likely to punish a firm by switching to a competitor if price increase. Altogether, this suggests that, while increasing competition may reduce prices in the long-term, competition policy cannot be a prominent short-term anti-inflation tool.

Empirical studies confirm that the increase in unit profits mainly reflects the rapid pass-through of higher input cost into selling prices and the comparatively slower adjustment in wages. When input prices rise, and assuming that the ratio between selling price and production costs – the mark-up - remains constant, the nominal profit per unit produced will also increase by the same proportion. Accordingly, the observed increase in unit profits does not necessarily entail higher profit margins. Recent evidence for Belgium and Italy indeed suggests that mark-ups played no role in the recent increase in profits (Colonna et al., 2023). Meanwhile, wages are generally set contractually or renegotiated at fixed intervals and hence adjust more slowly to shocks than prices. The rising contribution of ULC and other wage indicators from 2022 onwards points to a lagged reaction of labour compensation and suggest that the increase in unit profits may be temporary (Graph A). This is consistent with evidence from the US which suggests that higher unit profits could be a by-product of strong demand in markets where firms are price-takers and prices have risen to match demand to limited supply or margins could have increased temporarily in anticipation of future cost increases (Glover et al., 2023).

([1]) See for example E. and E. Hahn (2023) and Hansen et al. (2023).
([2]) Unit labour costs are compensation of employees per unit of real GDP and unit profits are gross operating surplus over real GDP.

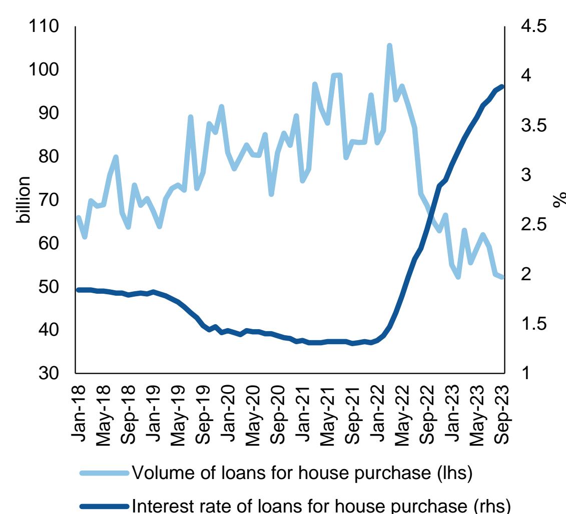
4. MACRO-FINANCIAL STABILITY

The euro area financial system has proven to be resilient, although tightening financial conditions may increase vulnerabilities. With the increase in interest rates and tighter credit conditions, the credit cycle has turned, both for households and corporates. Asset prices, and in particular real estate prices, are also coming under pressure. Although such an environment represents a challenge for financial institutions, the euro area financial sector has proven itself resilient, as euro area banks benefit from strong capital and liquidity buffers, as well as improved profitability. At the same time, the non-bank financial intermediation (NBFI) sector may be confronted with vulnerabilities. Further progress in the deepening of the European Economic and Monetary Union, including Banking Union and Capital Markets Union, would make the euro area even more resilient.

Credit conditions and dynamics

The tightening of monetary policy and lending standards coupled with lower credit demand led to a drop in new credit for both households and corporates. The total volume of new household loans for house purchase fell by 24% in the second semester of 2022 and by a further 18% in the first half of 2023. This reverses a multi-year upward trajectory that started in 2015 and reflects the sharp increase in borrowing costs **(Graph 4.1)**. The ECB's bank lending survey shows that the drop comes from falling demand for new credit, mainly due to the interest rate level. A deteriorating outlook for the housing market and lower consumer confidence has also had a significant impact on the demand for household credit. Meanwhile, new corporate loans also decreased by 4% in the first half of 2023.

Graph 4.1: **Cost of borrowing and volume of loans to households for house purchase**



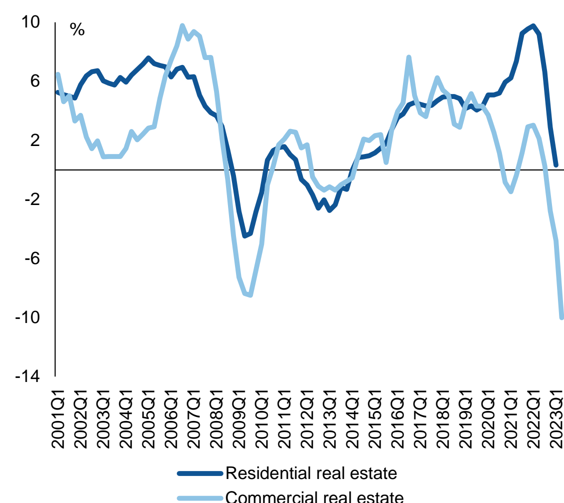
Source: ECB

Tightening financial conditions weigh on real estate prices. The euro area residential property market cycle appears to be at a turning point, as higher interest rates weigh on housing affordability. Residential real estate prices have been decreasing considerably since Q2-2022. In a number of Member States, including Luxembourg, Austria, Belgium, the Netherlands and Portugal, housing prices were far above the level suggested by fundamentals in 2022 ([12]). In the commercial real estate (CRE) sector, which is more sensitive to cyclical developments, price growth dropped sharply into negative territory **(Graph 4.2)**. The CRE market faces structural changes such as the impact of policies related to the green transition, a shift towards e-commerce and higher demand for flexibility in rentable office space (ESRB, 2023). Some of these changes may have been accelerated by the pandemic crisis and Russia's invasion of Ukraine. While the ongoing price correction is putting pressure on

([12]) For more detail see European Commission, 2023a.

investors, the speed and depth of the turn will determine the potential for stress on the financial system and the real economy (ECB, 2023b) ([13]).

Graph 4.2: **Residential and commercial real estate prices in the euro area**



(1) Year-over-year growth of nominal quarterly residential and commercial real estate prices
(2) Q2-2023 already available and included for the commercial property price indicator
Source: ECB

Asset quality has continued to improve but there are risks going forward. Banks' non-performing loan (NPL) ratios continued to decline – to historically low levels – although only marginally in the second half of 2022. At the same time, according to the ECB, early warning signs of asset quality deterioration became more pronounced, with some evidence of an increase in Stage 2 loan ratios ([14]) in 2022. They remain well above pre-pandemic levels and conceal considerable cross-country heterogeneity (ECB, 2023b). In the second half of the year, the ratio decreased slightly for non-financial corporations (NFC) loans while it continued to increase for households. Default rates have also recently shown an uptick for both corporate and retail exposures. The deterioration of economic dynamics and outlook in 2023 and higher interest rates may negatively impact asset quality.

Financial sector developments

The increase in interest rates has supported bank profitability but entails other risks. Banks' return on equity increased from an average of 1.9% at the end of 2020 to 6.8% at the end of 2022 **(Graph 4.3)**, supported by higher interest rates, low loan-loss provisions and, overall, a relatively slow adjustment of deposit rates. In 2023, the potential deterioration in asset quality could increase the cost of risk (losses and provisions). In addition, rising competition and a reallocation of funds from overnight to term deposits and wholesale funding might lead to an increase in funding costs, eroding profitability.

Capital levels and asset quality remain robust in the euro area banking sector. The Common Equity Tier (CET1) capital ratios of banks declined by 0.2 pps in 2022, to 15.7%, reflecting stronger lending and higher average riskiness of total assets. However, it stabilised at 15.8% in Q1-2023. In addition, the 2023 European Banking Authority (EBA) stress tests ([15]) confirmed the resilience of European bank's capitalisation, with capital ratios above the minimum requirements for almost all banks, even in an adverse scenario.

The banking sector holds substantial liquidity buffers and maintains strong funding ratios. Liquidity buffers mainly take

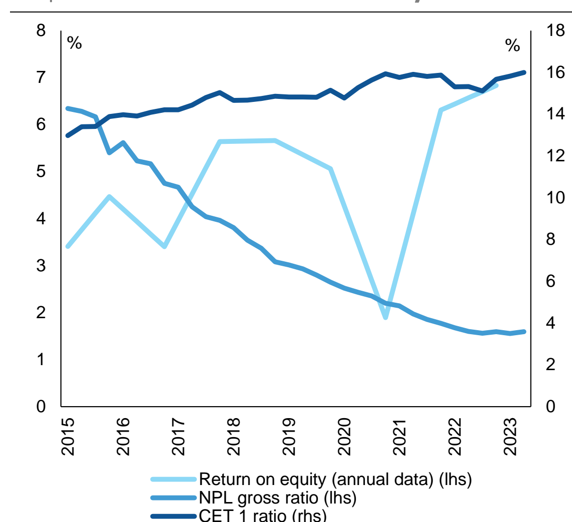
([13]) In 2023, the ESRB published a recommendation on vulnerabilities in the CRE sector in the EEA. Despite considering that there has been significant progress in closing CRE data gaps in recent years, such gaps persist in the CRE sector. See ESRB, 2022a.

([14]) Adopted in 2018, the International Financial Reporting Standard 9 (IFRS 9) aims to improve the recognition of banks' credit losses, on the basis of a more forward-looking estimation and loan-staging approach. Stage 1 consists of performing loans, Stage 2 underperforming loans that have seen a significant increase in credit risk, and Stage 3 credit-impaired loans.

([15]) The stress test involved 70 banks from 16 EU and EEA countries (of which 57 were euro area banks), covering 75% of the EU banking sector assets. Compared to the previous test, it included 20 additional banks and a detailed analysis on banks' sectoral exposures. See EBA, 2023.

the form of central bank reserves and government bonds. In addition, the high reliance on customer deposits and market funding via bonds (representing respectively around 50% and 15% of banks' liabilities in the euro area) helped increase the resilience of the euro area banks' funding base. Overall, banks' net stable funding ratios have declined only slightly since the end of 2021 and remain well above regulatory requirements. The gradual repayment of the ECB targeted long-term refinancing operations (TLTRO III) has so far not put strain on the funding ratios of banks.

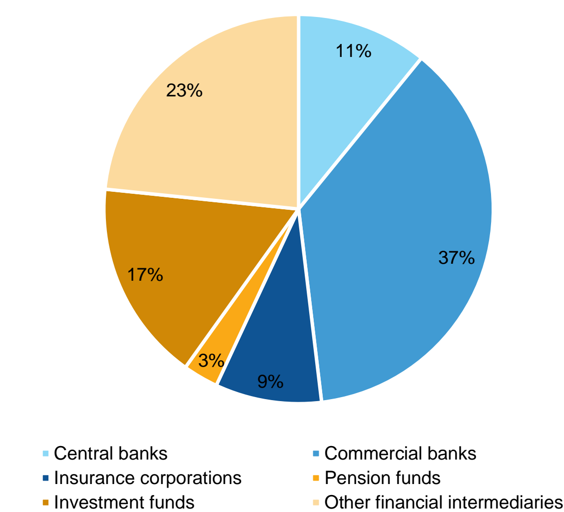
Graph 4.3: **Euro area bank stability indicators**



(1) NPL ratio covers gross non-performing debt instruments as a percentage of total gross debt instruments
Source: ECB

Meanwhile, the NBFI sector requires continued monitoring. The NBFI sector accounts for more than half of the assets of financial corporations' (including banks) in the euro area **(Graph 4.4)**. Assets of investment funds and other financial intermediaries account for about 40% of European financial sector assets. Non-bank credit granted to the NFCs stood at around 20% of external debt funding at the end of 2022, and more than 50% of newly-issued NFC debt was purchased by NBFIs. Credit risk in the aggregated NBFI sector declined during 2022 (ECB, 2023b). In addition, insurers' profitability and solvency remain robust in the euro area. Still, the NBFI sector remains vulnerable to price corrections due to macroeconomic uncertainty, a potential increase in the cost of risk, volatile markets and turning real estate cycle. The growing interconnectedness between NBFI and the banking sector means that distress in one sector may affect the financial system, with unwarranted effects on the real economy. Improving data quality and coverage of the NBFI sector to enhance its monitoring is therefore key for safeguarding financial stability (ESRB, 2022b).

Graph 4.4: **Euro area financial corporations (total asset share)**



Source: Eurostat

Deepening of the Economic Monetary Union and policies to improve financial stability

Macroprudential policy contributes to safeguard financial stability. In a high-uncertainty environment, with downside risks to economic growth, macroprudential policy can help strengthening resilience of the banking and financial system. In that respect, capital-based and borrower-based measures are complementary. According to the ESRB, macroprudential policies in several euro area Member States tightened between April 2022 and March 2023, including as regards capital buffers (ESRB, 2022c).

Progress in the Banking Union contributes to the resilience of the euro area's financial system. Ensuring financial stability

is crucial at a time of high inflation and tightening financial conditions. The banking turmoil caused by the failure of several mid-sized banks in the US and the collapse of a large Swiss-based bank in spring this year has recalled the importance of sound regulation and effective supervision, as well as of a predictable crisis management and and ensuring better protection of all depositors. In particular, the Single Supervisory Mechanism (SSM) plays an essential role in ensuring that banks are well prepared for and resilient to adverse economic and financial developments. The SSM has rapidly adapted to emerging supervisory challenges, as well as to unexpected adverse events, such as the COVID-19 pandemic and the Russian invasion of Ukraine and subsequent economic turmoil. As part of the work on the Banking Union, the Commission proposed a reform of the bank crisis management and deposit insurance framework in April 2023. It aims to broaden the applicability of resolution powers to mid-sized and smaller banks, while improving resolution funding arrangements, including by facilitating a more flexible use of national deposit guarantee funds. The review of the crisis management and deposit insurance should pave the way for further progress towards the completion of the Banking Union, including a European Deposit Insurance Scheme and deeper market integration.

NBFI vulnerabilities also highlight the need to strengthen the resilience of this sector from a macroprudential perspective. Structural vulnerabilities related to liquidity and leverage highlight the need to progress on policies aimed at enhancing liquidity preparedness to meet large margin and collateral calls in derivatives and repo markets, containing leverage-related risks, and tackling liquidity mismatch in open-ended investment funds.

Introduction of a digital euro could spur efficiency and innovation in the European payments markets, unlock benefits for the euro area economy, and foster the international role of the euro. The digital euro is a digital form of central bank money, which would offer consumers and businesses an additional choice for their payments everywhere in the euro area. The digital euro would be complementary to cash. Benefits include safeguarding the key role of risk-free public money for the monetary system and enhancing financial inclusion. Moreover, it could help support the digital transition, reduce fragmentation and promote innovation in the European payment system. In that context, the digital euro could support FinTech innovation by providing a common and pan-euro area standard on which innovative use cases, such as automated payments in a machine-to-machine environment, can be developed, while the digital euro's interoperability with the EU Digital Identity Wallet could provide for a seamless customer authentication process and add another layer of privacy in retail payments. A digital euro would also contribute to strengthening the international role of the euro and Europe's open strategic autonomy. On 28 June 2023, the Commission has adopted a legislative proposal that would establish the digital euro and regulate its essential aspects. The ultimate decision on its eventual issuance lies with the ECB, who could start issuing the digital euro after completion of the legislative process. In parallel with the retail digital euro, the ECB is engaging in exploratory work on the potential of new technologies for existing wholesale settlement systems.

Ratification of the amended European Stability Mechanism (ESM) Treaty would further strengthen the euro area's macro-financial stability architecture ([16])**.** The ESM reform was agreed in 2020 by Eurogroup members, however as the amended ESM Treaty has not yet been fully ratified, the reform has not been finalised. The ratification of the amended ESM Treaty would operationalise the ESM's financial backstop to the Single Resolution Fund (SRF), make crisis management arrangements more credible **(see Box 4.1)**. By providing a common backstop for the funds available to manage a bank crisis, the amended ESM

([16]) See the ratification details on the Agreement Amending the Treaty Establishing the ESM: https://www.consilium.europa.eu/en/documents-publications/treaties-agreements/agreement/?id=2019035&DocLanguage=en

Treaty would limit divergence in financial conditions.

Financial risks related to nature loss and climate change need to be further assessed and monitored. As regards climate change, the ECB/ESRB Project Team (ESRB, 2022d) emphasises the need for a macroprudential approach as regards systemic aspects of climate-related risk. In 2023, the European Commission mandated the European Supervisory Authorities and asked the ECB to undertake a coordinated one-off assessment of financial stability risks in line with the Fit-for-55 package. The outcome of that assessment, expected in Q4-2024/Q1-2025, will inform the future work programme of the Union in that area.

Box 4.1: Financial architecture of the euro and role of the ESM

The European Stability Mechanism (ESM) reform, agreed in 2020 by Eurogroup members, entrusts, among other changes, the ESM to become the backstop to the Single Resolution Fund once the amended ESM Treaty is fully ratified. With its contribution to the funds available in case of a bank resolution, the common backstop would help ensuring that the ability to provide funding for resolving banks is delinked from the creditworthiness of the Member State where a bank is located, thus limiting divergence in financial conditions. The introduction of a common backstop to the Single Resolution Fund would thus strengthen and add credibility to the euro area's crisis management toolkit. The proposed ESM reform aims to simplify and clarify the eligibility conditions to access ESM precautionary credit lines and it tasks the ESM with the monitoring of macro-financial risks in the euro area to prepare for potential adjustment programmes. However, as the amended ESM Treaty has not yet been fully ratified, the reform has not been finalised. In the meantime, following its accession to the euro area, Croatia joined the ESM in March 2023.

The amendments to the ESM Treaty have not addressed the issue related to its institutional nature. The ESM remains a purely intergovernmental body operating under public international law. Recently, European Court of Auditors (ECA) published a special report on the EU's financial architecture recommending that, once the ESM Reform is fully ratified, a broader reflection on a possible integration of the ESM in the EU legal framework takes place. ([1]) Before the ECA report, the case for an ESM integrated into the EU legal framework has been made on several occasions. For example, the "Five Presidents' report on completing the Economic and Monetary Union", issued in 2015, underlined that the ESM's intergovernmental structure entailed a complex governance and lengthy decision-making processes, and advised to integrate the institution within the EU Treaties. Similar positions were adopted by the European Parliament ([2]) when reflecting on the future of the Economic and Monetary Union.

In 2017, the European Commission presented a proposal to integrate the ESM in the EU legal framework through its transformation into a union body, the "European Monetary Fund". The Commission's proposal aimed at strengthening the institutional anchoring of the ESM and aligning its governance with other EU bodies through the introduction of qualified majority voting and increased accountability towards the European Parliament. Overall, the integration of the ESM into the EU legal framework could simplify the ESM's governance and make it more agile, allowing to respond to any unfolding crises more promptly and efficiently.

([1]) The ECA recommends that by 2025, the European Commission engages with the Council and the parliament with a view to finalise the integration of the ESM into the EU legal framework. See ECA, 2023.
([2]) See European Parliament, 2013.

ENHANCING EURO AREA COMPETITIVENESS

5. STATE OF PLAY ON COMPETITIVENESS DEVELOPMENTS

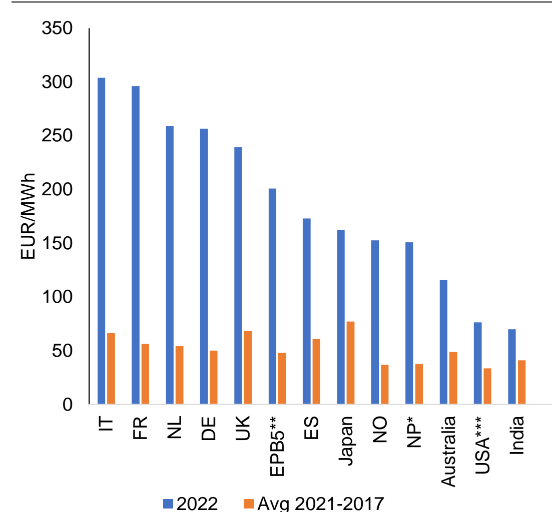
The fast rise in both energy prices and nominal wages since 2022 has dented cost competitiveness in the euro area and heightened divergences. The significant increase in energy prices since 2021 compared to trade partners puts euro area companies at a disadvantage on export markets. The depreciation of the euro in 2021 and part of 2022 compared to the rest of the world might have offset part of the deterioration. Still, the negative impact on exports has been visible in more energy-intensive countries and sectors, putting the strengthening of the euro-area competitiveness to the political fore. Differences in inflation across the euro area remain elevated (see Section 1), raising concerns about reallocation pressures in a context of global fragmentation and the developments of internal imbalances.

In the longer-term, productivity growth and the ability of the euro area to innovate will drive competitiveness. Aside from relative production costs, multiple non-cost factors contribute to the euro area's competitiveness, including in particular the ability to innovate. This makes competitiveness a multi-dimensional concept that reflects the ability for an economy to grow within an integrated trade system without creating imbalances. In that respect, the persistent gap in productivity growth compared to international peers, and rising risks of geoeconomic fragmentation could put the euro area at a disadvantage **(see Box 5.1)**.

Price and cost competitiveness

High energy prices in the euro area have eroded its cost competitiveness with international partners. The global increase in energy prices has affected the euro area more than several of its trading partners. In particular, in 2022, electricity prices rose more steeply than in the US and other trade partners (Tertre et al., 2023) **(Graph 5.1)**. Similarly, in 2022 wholesale gas prices in the euro area were on average 13 times higher than in 2020, while those in the US and Asia were 3.5 and 9 times higher respectively (Emter et al., 2023). The share of firms reporting an increase in energy costs as a barrier to investment rose to 87% in 2022, up from 69 % in 2021 (EIB, 2023a).

Graph 5.1: **Electricity prices in selected euro area countries and international peers**

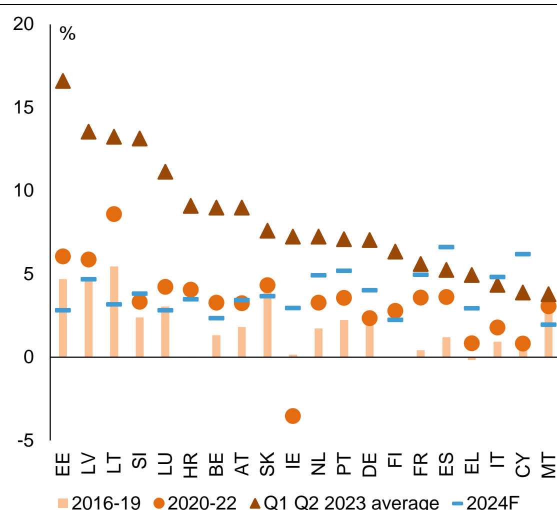


(1) *NP stands for wholesale electricity prices of the Nord pool market (NO, DK, FI, SE, EE, LT, LV)
(2) **EPB5 stands for European Power Benchmark. It represents the weighted average of wholesale electricity prices of main EU electricity markets (DE, ES, FR, NL) and Nord pool market (NO, DK, FI, SE, EE, LT, LV)
(3) ***USA is the arithmetic average of the day ahead prices of the following most representative US power Hubs: PJM Western, NYISO Hudson Valley, MISO Indiana, ISONE Internal , ERCOT North , CAISO SP15.
Source:: S&P Global Platts, Japan Electric Power Exchange (JEPX), Indian Energy Exchange Limited IEX India

Despite their substantial drop since the beginning of the year, energy prices in the euro area are likely to remain higher

than before the crisis. In particular, the substitution of Russian gas supplies could imply structurally higher costs and prices ([17]). The EU has stepped up efforts to move away from fossil fuels to renewable energy but during the transition its competitiveness will continue to be affected by many factors including the price of imported energy.

Graph 5.2: **Growth in unit labour costs (average annual growth nominal ULC) between 2016-19, 2020-22, Q1 and Q2 2023 and 2024 forecast**

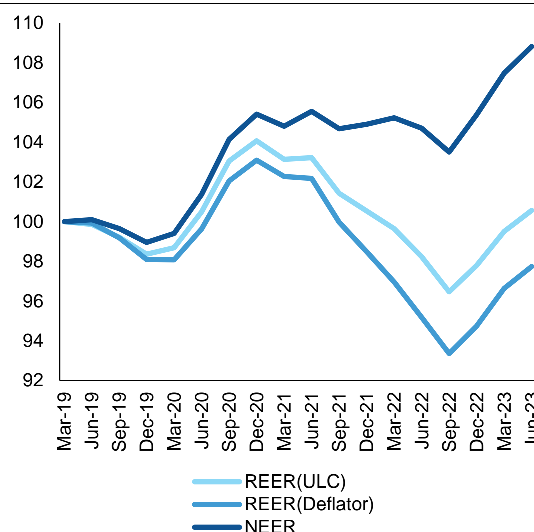


Source: Eurostat and EU Commission Economic Forecast Autumn 2023

Unit labour costs (ULC) accelerated in most countries in 2023. ULC increased markedly in the year ending in Q1 2023 in a number of euro area countries most notably the Baltic countries and Slovakia (rising to significantly higher than pre pandemic level) **(Graph 5.2).** This considerable rise in ULC was mainly due to sharp wage increases, while productivity stagnated. In 2024, ULC are expected to slow down as wage growth moderates and productivity is expected to increase. Increased use of environmental taxation could help reduce the burden on labour, further reducing unit labour costs and improving the EU's cost competitiveness over the medium-term. In particular, there is potential to increase resource and pollution taxes in line with the polluter pays principle, as these taxes only make up a small share of environmental tax revenues, accounting for 3.5% of environmental tax revenues in 2021 (European Commission, 2023f). Environmental taxes can be less distortive than other more commonly used types of taxation, e.g., labour or capital taxation, that were designed primarily with the objective to raise revenues.

Overall, the euro's real effective exchange rate appreciated compared to world trading partners in 2023 and trade performance in energy-intensive sectors suffered. The real effective exchange rate of the euro vis-à-vis a broad range of trading partners depreciated in 2021 and in the first part of 2022 but it appreciated more recently. As of Q2 2023, the euro's real effective exchange rate (HICP based) appreciated by about 2 pps since Q4 2019.

Graph 5.3: **Euro Real Effective Exchange Rate**



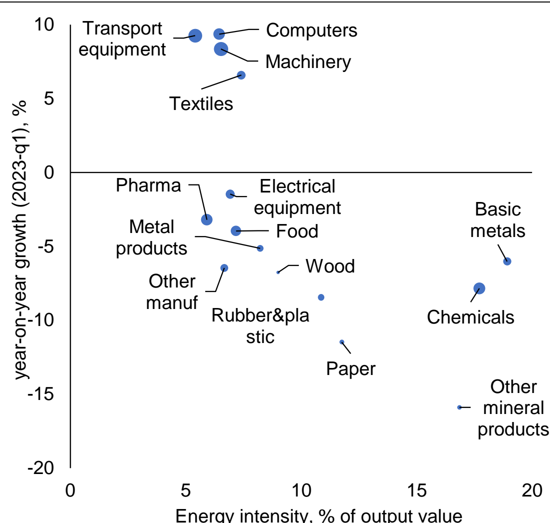
(1) REER refer to the real effective exchange rate of the euro against the currencies of 37 of the euro area's most important trading partners. A positive (negative) change corresponds to an appreciation (depreciation) of the euro.
Source: European Commission.

Euro area companies rate their competitiveness at an all-time low, especially in high energy-intensive

([17]) The replacement of Russian gas pipeline supply by a diversified supply of LNG via cargoes. LNG includes processes (liquefaction, transport by sea at very low temperatures, regasification) which result in higher costs as compared with gas delivered by pipeline.

sectors such as chemicals ([18]). Looking at trade developments, euro area export growth over the past 2 years mainly reflects depressed global demand and supply bottlenecks, with energy costs having a limited impact ([19]). However, exports in energy-intensive sectors have decreased strongly over the past year. Exports of mineral products, basic metals and chemicals were affected the most (**Graph 5.4**).

Graph 5.4: **Energy intensity and euro area export growth by sectors**



Source: Eurostat.

High inflation has had a particular impact on SMEs. While headline inflation reached more than 10% in 2022, the inflation experienced by businesses in certain sectors was much higher, with rates of up to 28.5% in the energy-intensive industries and 55% in energy renewables in the third quarter of 2022, followed by agri-food (over 15% in the first half of 2022) ([20]). This inflation had impacts on SMEs in a variety of ways: on late payments, bankruptcies, investment, the adoption of digital and green technologies, participation in public procurement, access to skilled labour and, ultimately, profitability. While the effect of each impact in isolation may appear small, the total effects add up significantly from the perspective of a single firm. The effect is particularly pronounced on those firms that were unable to pass cost increases onto consumers – more often SMEs.

Over the last 2 years, the relative competitiveness of the economies of the euro area countries has diverged considerably. Since December 2019, the currencies of the Baltic countries and Slovakia appreciated significantly in terms of real effective exchange rate (REER) compared to the euro and the currencies of other trading partners. Such large divergences in price competitiveness, if sustained, raise concerns about possible imbalances within the euro area. In parallel, for part of the euro area, relative changes in cost competitiveness have resulted in some rebalancing. A number of Member States with some pre-existing cost competitiveness weaknesses, including for example Greece and Italy, recovered some ground relative to their peers thanks to more moderate wage growth since December 2019.

The EU and Member States introduced several initiatives to mitigate the impact of the energy crisis and support companies. In response to the energy crisis, Member States have made efforts to improve efficiency and reduce energy demand and to develop renewable energy. The EU reduced its demand for gas by 17% of gas between August 2022 and July 2023 compared to the average of the previous 5 years ([21]). In light of the economic difficulties faced by SMEs, the SME Relief Package, adopted on 12 September 2023, has renewed the Commission's commitment to ensuring a business-friendly regulatory environment that helps SMEs to be productive, competitive, and resilient ([22]). In addition, Member States resorted to State aid to support specific sectors and companies adversely impacted by

([18]) European Commission Business and Consumer Survey (BCS).

([19]) ECB modelling shows that the recent energy supply shock has contributed to dampen export growth although its relative importance was lower than the deceleration in global demand conditions and the effects of supply bottlenecks. See Emter et al., 2023.

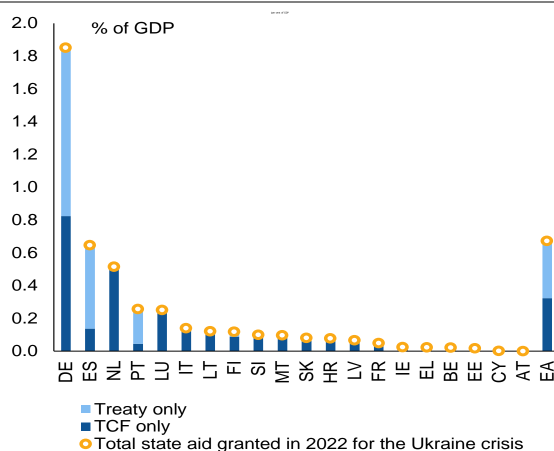
([20]) European Commission, 2023g.

([21]) Eurostat.

([22]) See European Commission, 2023h and European Commission, 2023i.

the energy crisis. The state aid framework was adapted (Temporary Crisis Framework introduced in March 2022) to define criteria for the assessment of the compatibility of corporate support with Single market rules in the context of the energy crisis. The overall budget notified by Member States and approved by the Commission as part of temporary State aid measures in 2022 came to nearly EUR671.78 billion, representing 4.3% of combined EU27 GDP in 2022. More than half (53%) of this budget was approved in Germany **(Graph 5.5)** ([23]).

Graph 5.5: **Granted state aid amount for 2022 (per cent of GDP)**



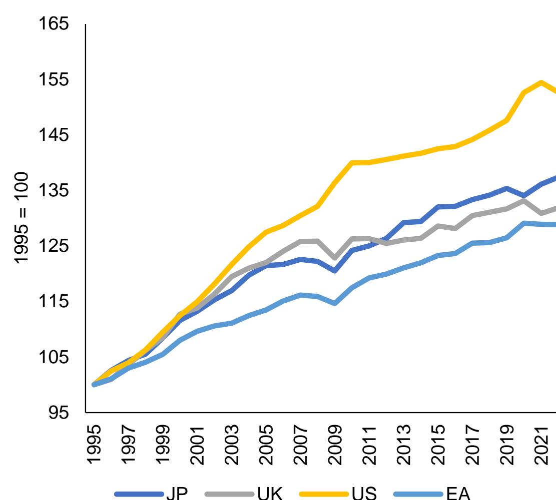
Source: European Commission.

PRODUCTIVITY

Labour productivity growth has steadily declined in the euro area since the early 2000s. The reasons for this slowdown remain a topic of scholarly and policy debate (Lopez-Garcia et al., 2021 and Andrews et al., 2015). While other advanced economies have experienced this slowdown, it has been more pronounced in Europe compared to for example the US. The productivity gap between the two regions has further widened for that reason **(Graph 5.6)**. There is also substantial heterogeneity across euro area Member States, suggesting a risk that economic divergence could expand going forward, complicating the conduct of a single monetary policy.

The slowdown in labour productivity reflects both sluggish investment and a broad-based deceleration of technological progress. The labour productivity slowdown in the euro area is largely attributable to the persistence of relatively sluggish investment after the 2008 financial crisis (less capital deepening), a situation that Europe shares with the US (Licchetta et al., 2022a). An important difference between the two areas is the performance in terms of total factor productivity (TFP), where the euro area is lagging behind (Licchetta et al., 2022b). In the longer-term, evidence suggests that patents are becoming less disruptive (Park et al., 2023) and tend to require more resources to produce (Bloom et al, 2020).

Graph 5.6: **Labour Productivity (Index 1995=100)**



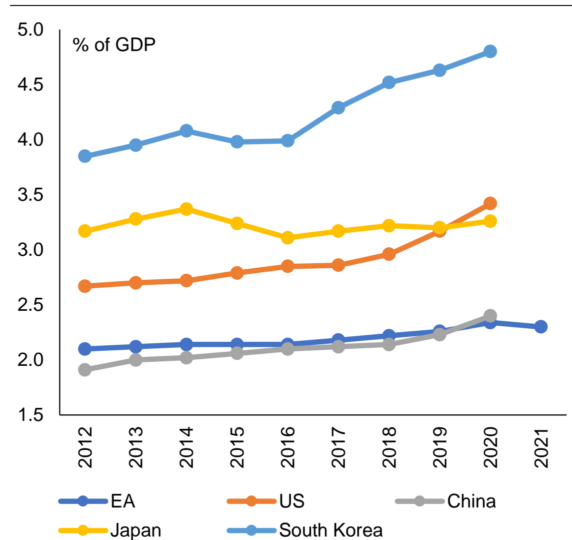
(1) GDP per hour worked, constant prices, 2015 PPP.
Source: OECD

The euro area's innovation performance has been lagging behind that of the US and Japan. In 2021, euro area countries spent on average 2.3% of their GDP on Research and Innovation (R&I) compared to around 3.4% in the US **(Graph 5.7)**. Most of corporate R&I spending in the EU is

([23]) The amount granted are quoted in nominal terms, including in particular the full amount of guarantees, which may or may not be called upon. Information on the corresponding expenditures is available with a delay of about a year.

concentrated in the automotive industry, ICT products and services, and health care (European Commission, 2023m). The euro area is strong on advanced manufacturing and advanced materials, but it lags behind in critical fields, such as artificial intelligence (AI), big data, cloud computing, cybersecurity, robotics and microelectronics (European Commission, 2022a). Europe's disadvantage in key sectors is particularly problematic at a time when rising geopolitical tensions imply that technological leadership and the capacity for open strategic autonomy go hand-in-hand.

Graph 5.7: **Expenditure on Research and Innovation (% of GDP)**

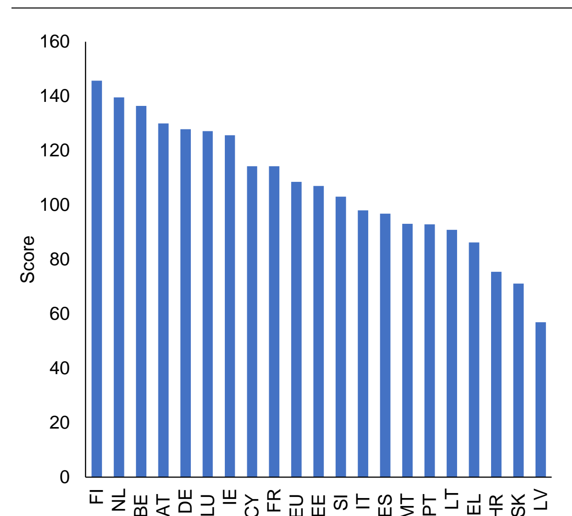


(1) Gross domestic expenditure on R&D
Source: Eurostat and OECD.

Europe is lagging behind on digitalisation. TFP growth in Europe lagged behind the US, in particular in the area of ICT (manufacturing of computers and electronics, IT services). US TFP growth in the ICT sector reached its highest level during 2013-2019 and the TFP growth gap between the EU and the US was particularly pronounced during this period. The EU's ICT sector accounted for 4.9% of EU GDP in 2021, and its share in the global ICT market fell from 21.8% in 2013 to 11.3% in 2022. This has also had repercussions in other areas. For example, in 2022, only 69% of SMEs in the EU reached a basic level of digital intensity and, in 2021, only 8% of companies in the EU used AI technologies.

Innovation, including on green technologies, is uneven across the euro area. Most innovation leaders and most strong innovators appear to be located in Northern and Western Europe, and most of the moderate and emerging innovators appear to be located in Southern and Eastern Europe **(Graph 5.8)**, which makes productivity convergence harder to achieve Similarly, on the number of green patents, several Member States (e.g. Austria, Finland and Germany) have been solid innovators, but multiple countries registered less than one green patent per million inhabitants. Failure to master key technologies related to the green transition could cause structural divergences between euro area countries in the medium-term.

Graph 5.8: **Innovation Index**

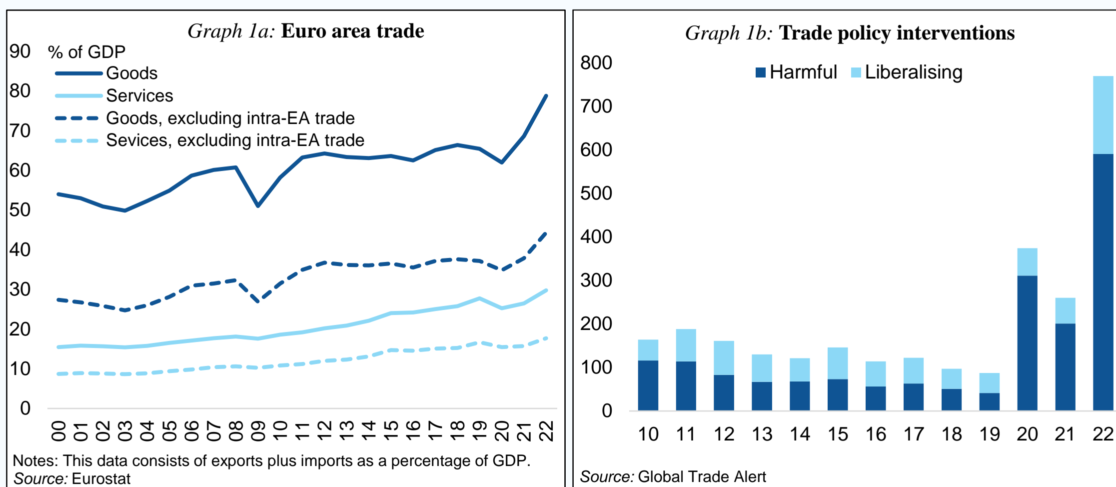


(1) Summary Innovation Index
Source: European Innovation Scoreboard.

There are significant differences in productivity growth rates also at the regional level. Over the 2001-2021 period, many less developed regions, especially those located in the Eastern Member States, had above average productivity and employment growth, offset only slightly by a decline in the share of working-age population, so that growth of GDP per head was above the EU average. This, however, masks the fact that in a number of these less developed regions, GDP per head fell over this period, with productivity falling and the employment rate declining or increasing relatively little (European Commission, 2022b).

Box 5.1: **Risks of geoeconomic fragmentation**

The euro area economy is strongly integrated in global markets. Europe represented about 16% of the world's trade in 2022. The euro area trade-to-GDP ratio is significantly higher today than in 2000. Conversely, trade is a critical contributor to growth in the euro area, with trade flows between the euro area and the rest of the world reached more than 60% of euro area output **(Graph 1a)**. Two thirds of the EU's imports are inputs, such as raw materials, that contribute to downstream activities in domestic production processes (IMF, 2023).



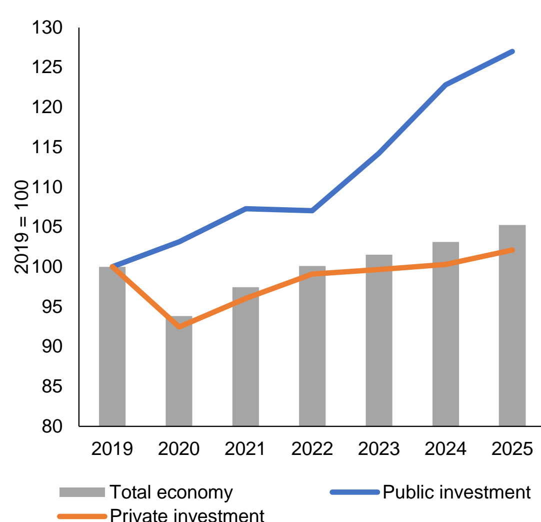
Geopolitical tensions and post-COVID supply chains realignments risk future adjustments of trade flows. The number of non-tariff barriers to trade has risen significantly since 2020 (Gaal et al., 2023) and countries are increasingly using foreign investment screening measures for reasons of national security (Panetta, 2023). Harmful interventions to trade increased in 2020 due to the pandemic crisis and in 2022 **(Graph 1b)** as a result of Russia's war against Ukraine and the ensuing food and energy crises. These tensions have already contributed to reorienting of trade flows, in particular between the United States and China, and companies need to undertake measures to increase the resilience of supply chain in the face of geopolitical uncertainty (EBRD, 2022).

Such global trade fragmentation is likely to produce high economic costs. Recent tensions between the US and China, the COVID-19 pandemic, and the Russian war of aggression against Ukraine have put pressure on trade integration efforts. The ECB estimates that a global trade fragmentation scenario would lead to welfare losses, captured by the change in gross national expenditure, of around 1% to 2% in the euro area with losses in the euro area would be somewhat greater than those of the United States or China owing to its greater trade openness (ECB, 2023c).

6. SUPPORTING INVESTMENTS

Promoting investment is at the core of the EU's recovery strategy. The COVID 19 crisis led to a sharp drop in investment, mainly due to private investment contraction. However, contrary to the aftermath of the global financial crisis, investment rebounded fast after the COVID-19 pandemic **(Graph 6.1)**. This was linked, in particular, to the supportive monetary stance, to the resilience of financial markets and to a decisive policy reaction to support public investment.

Graph 6.1: **Investment sectoral breakdown, euro area (volumes, 2019 = 100)**

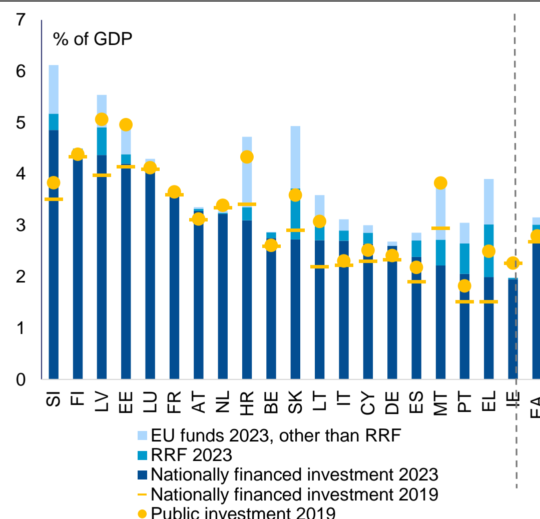


(1) public and private investment volumes are calculated based on total investment deflator
(2) public investment includes aggregates of general government GFCF and GFCF financed with RRF grants
Source: European Commission

Private investment is slowing down due to tightening financial conditions. Following the series of sharp policy rates hikes by the ECB (see Section 2), financial conditions tightened significantly, affecting credit dynamics. Most of enterprises expect further worsening of their access to bank financing and credit lines ([24]). The impact is particularly strong for construction investment, as tighter financing conditions are compounded by a drop in demand given the downturns in housing markets.

Policies to support investment

Graph 6.2: **Public investment in 2019 and 2023 by financing source**



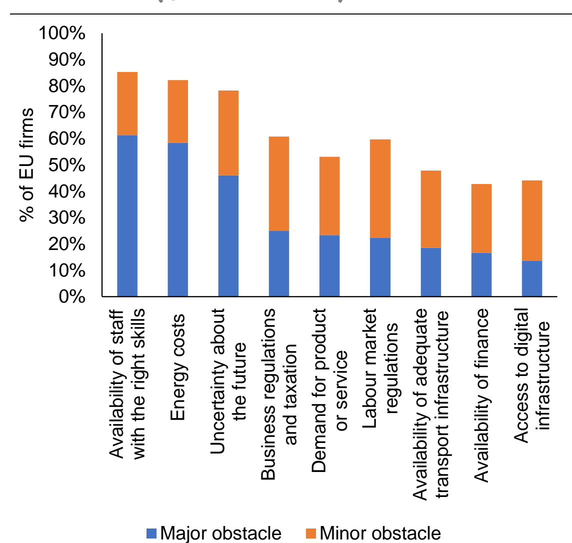
Source: European Commission

The Recovery and Resilience Facility (RRF) and cohesion policy funds provide a substantial boost to public investment and implementation should continue without delays. The RRF, which is part of the Next Generation EU (NGEU), makes available EUR 723 billion to support investment and reforms. Two years into implementation, the RRF has contributed to the recovery in public investment (**Graphs 6.1 and 6.2**), including deployment of green technologies, modern digital infrastructures, as well as green and

([24]) 28th Survey on the Access to Finance of Enterprises (SAFE), ECB 2023.

digital and skills development. The RRF is also expected to crowd-in more private investment (Pfeiffer et al. 2023). Although Member States are on track with their recovery and resilience plans, some - particularly Member States with very large allocations - are lagging behind on grant absorption. (European Commission, 2023j). Cohesion policy funds are also a crucial source of public investment funding. While Member States are finalising the implementation of the 2014-2020 funds, in 2021-2027, an additional EUR 392 billion is available to invest in the green and digital transitions. The implementation of these funds has started to pick up pace with, however, certain challenges.

Graph 6.3: **Perception of long-term barriers to investment (% of EU firms)**



(1) Survey answers for question: "Thinking about your investment activities, to what extent is each of the following an obstacle? Is a major obstacle, a minor obstacle or not an obstacle at all?"
(2) Data for all surveyed firms from all sectors; data for answers for "no obstacle" and "don't know/refused" are not shown.
Source: European Investment Bank Investment Survey (EIBIS) 2023

Persisting obstacles weigh on investment, both private and public ones. Administrative hurdles, linked in particular to permitting, undermine investment, particularly for projects related to the green transition. In addition, enterprises, regardless of size, consider the lack of skilled labour and increasing production costs to be among their biggest concerns **(Graph 6.3)** (European Investment Bank, 2023a). Such obstacles limit the ability of firms to invest, and therefore have an impact on potential growth. They also impede a successful roll out of RRPs and cohesion policy funds. Accordingly, the 2023 revision of the euro-area Member States' plans aim to introduce additional reforms and investments, which are set to address specific regulatory hurdles and investment bottlenecks identified in the RRPs implementation so far (European Commission, 2023j).

Supporting the Green transition

In the context of the energy crisis and the need to accelerate net-zero industries, major EU trading partners have taken action to support investment in such technologies. The success of Chinese global firms as producers of goods needed for the green transition (e.g., solar panels, batteries, electric vehicles, wind turbines) is surely determined by fundamental cost advantages but also the extensive use of government subsidies (Springford and Tordoir, 2023) Another key policy factor in this respect relates to different degrees of ambition of environmental policy across world areas. The approach to address climate-related issues chosen by the EU has centred on emission pricing and flanked by a variety of measures to support the development and deployment of green technology. Since the adoption of the Inflation Reduction Act in 2022, the US approach has been based mainly on large-scale subsidies to green technologies. While the jury is still out given the short timeframe since IRA adoption, such policy differences could have implications for competitiveness on a global scale, potentially leading to price pressures to relocate industry abroad (Clausing and Wolfram, 2023).

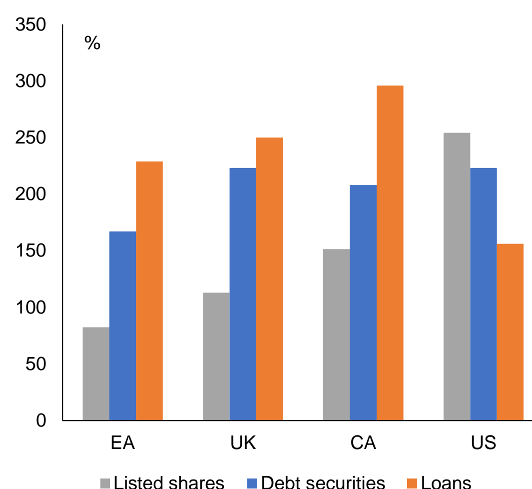
Support for industries that are critical to the green transition is essential even though it entails some risks. Policy actions to support the green transition range from an acceleration of permitting and administrative procedures to industrial policy tools such as public subsidies and public procurement rules that introduce (within limits) a preference for domestic production. Industrial policy has been

shown to be a powerful tool to complement carbon pricing and ensure a speedy and cost-effective way to boost innovation and rapidly shift towards climate neutrality (Acemoglu et al., 2012). Strengthening "strategic" industries that are considered critical for the net-zero transition of the economy is needed to avoid developing excessive dependencies from non-EU suppliers, while providing also a response to initiatives to subsidise green technologies by other major world regions, including China and the US (Inflation Reduction Act) (European Commission 2023k and Tagliapietra et al., 2023). Incentivising circular economy approaches in industry is also crucial to further reduce both greenhouse gases and other pollutants' emissions, boost resource efficiency and reduce critical dependencies, thus strengthening the EU's resilience and competitiveness. Nonetheless, while industrial policy is an important tool, it should not be seen as a panacea towards sustainable growth, notably because it will carry some downsides at the domestic and international level (Terzi, 2023). On the domestic side, if industrial policy is not well designed (Terzi et al., 2022), it is at risk of reducing competition and consequentially the rate of innovation, leading to higher prices for consumers. On the international side, a costly subsidy race between major economies could lead once again to increasing price and budgetary pressures.

The use of state aid to support strategic sectors carries important risks to the single market and may aggravate divergences within the euro area. In line with the March 2023 revision of the Temporary Crisis and Transition Framework (TCTF), a number of countries are using state aid to support the green transition. However, the greater reliance on state aid at national level runs the risk of destabilising the level playing field within the single market and missing the opportunity of fully exploiting economies of scale at the EU level. Absent some coordination in industrial strategy, larger Member States or those with greater fiscal space may have greater scope to support companies, to the partial detriment of other euro area countries and the integrity of the European Union. For that reason, the Commission put in place the Innovation Fund to support the demonstration of innovative low-carbon technologies via EU-wide competitive calls for large-scale and small-scale projects. The Commission has been arguing further in favour of a European mechanism to support companies (Strategic Technologies for Europe Platform, STEP) and has taken measures to ensure the resilience of supply chains, including for Critical Raw Materials that constitute a crucial input to green technologies.

Developing capital markets

Graph 6.4: **Size of the different markets in terms of GDP**

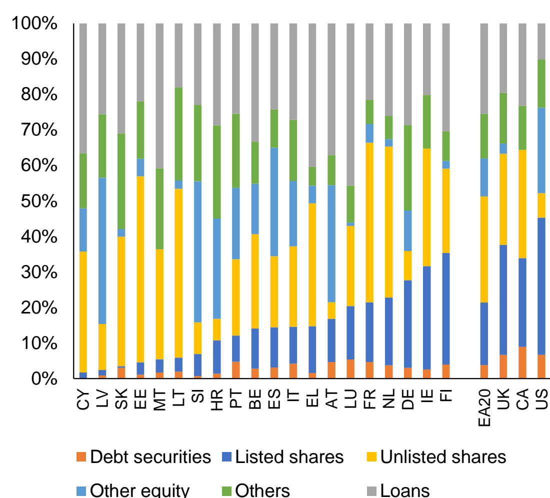


(1) 2021, latest available data
Source: Eurostat and OECD

Companies in the euro area predominantly use bank loans and their use of market-based finance remains limited. Loans represent close to 26 % of total liabilities of non-financial corporations while the share of tradable instruments (debt securities and listed equity) stands at 21 %. Market-based funding is much higher in Canada, the United Kingdom and the United States, where it stands at 34 %, 38 % and 45 %, respectively **(Graph 6.4)**. The difference can partly be explained by a high share in the euro area of small and medium enterprises (SMEs) and family-owned businesses, which are financed predominantly through loans. As

a result, the size of capital markets (equity and debt securities) in the euro area is smaller than that of other large economies. In 2021, loan liabilities in the euro area represented 229 % of GDP, while debt securities were 169 % of GDP, and listed shares represented only 82 % of GDP **(Graph 6.5)**. By comparison, in the United States, loans represent 156 % of GDP, while listed shares and debt securities are respectively 254 % and 223 %.

Graph 6.5: **NFC's share of liabilities by different types**

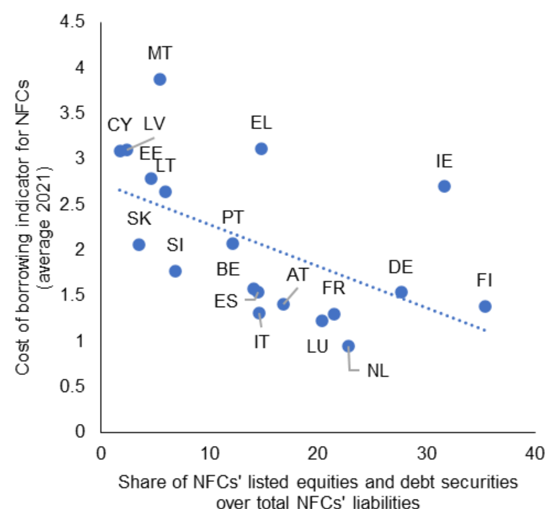


(1) 2021, latest available data
Source: Eurostat and OECD

In addition, capital markets in the euro area remain fragmented along the national lines. On average in the euro area, 78 % of equity and 49 % of debt securities held by investors are issued in the same Member State. Such a large home bias in security holding leads to disparities in capital costs and obstacles with respect to the access to financing across the euro area. It results in higher financing costs for companies and curtails potential returns for investors. Another sign of fragmentation is the large number of national and regional stock exchanges that continue to coexist in the EU, more than 30 compared to only a few in the United States.

The Capital Market Union agenda aims at reducing fragmentation, increasing access to finance and, in turn, supporting innovation and competitiveness. Fragmented capital markets imply lower competition among financial institutions, high liquidity premia, and eventually a higher cost of funding. Evidence shows a strong correlation between access to capital market and cost of funding **(Graph 6.6)**. Stronger and integrated capital markets can increase financing opportunities for innovative companies that are often based on intangible capital and have comparatively little physical collateral to secure bank loan. The development of innovative companies, and in particular start-ups, is therefore particularly dependent on the existence of well-developed capital markets. In particular, venture capital funds play a central role by supporting young, fast-growing companies. In the last ten years, venture capital investments have slowly increased in the euro area but remain significantly below those in the United States **(Graph 6.7)**.

Graph 6.6: **Correlation between cost of borrowing for firms and the share of NFC's listed equities and debt security over total NFC's liabilities**

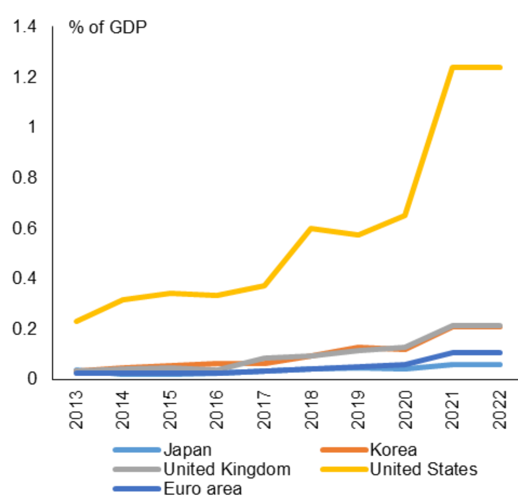


Source: ECB and OECD

In September 2020, a new CMU Action Plan was rolled out. The plan sets out three key objectives: to make financing more accessible for European companies, in particular SMEs, to increase citizen's confidence and participation in capital markets, and to integrate national capital markets into a genuine EU-wide single market for capital. The Commission has now delivered on all of the 16 actions included in the plan.

Stronger capital markets can enhance the international role of the euro. The euro's global role remained resilient during the pandemic and despite Russia's aggression towards Ukraine (ECB, 2023d). The euro has consolidated its position as the second most used international currency. However, the euro´s global role continues to punch below the euro area's economic and financial weight. In that respect, a deeper EMU, supported by a more integrated and better functioning Capital Markets Union would strengthen the international role of the euro.

Graph 6.7: **Venture capital investments as a share of GDP (stock)**



Source: OECD

ANNEXES

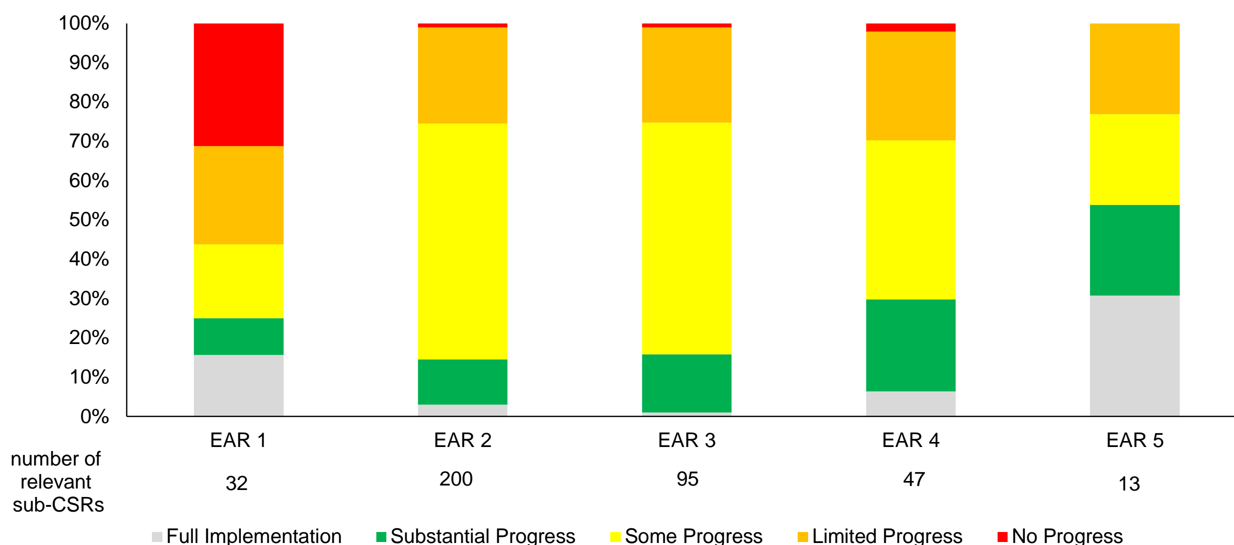
Graph A1.1: **Progress towards SDGs in the European Union**

Data based on EU progress as consolidated data for the euro area is not available
Source: Eurostat

Over the last five-year period, the EU has made significant progress towards ensuring decent work and economic growth (SDG 8) and reducing poverty (SDG 1). Significant progress has also been made towards achieving gender equality (SDG 5). Good but more moderate progress has also been achieved towards the goals on reducing inequalities (SDG 10), ensuring quality education (SDG 4), fostering peace and personal security within the EU's territory and improving access to justice and trust in institutions (SDG 16), health and well-being (SDG 3), despite the setbacks caused by the COVID-19 pandemic, and on innovation and infrastructure (SDG 9). Progress towards the remaining goals - zero hunger (SDG 2), clean water and sanitation (SDG 6) and affordable and clean energy (SDG 7) - has been less significant.

More progress is expected for three goals – climate action (SDG 13), life on land (SDG 15) and global partnerships (SDG 17) – as EU Member States are set to implement the higher level of ambition in the environmental targets set at EU level. Regarding climate action (SDG 13), the EU has set very ambitious and unparalleled climate targets for 2030 and, as compared to past trends, they will require more efforts. The EU has already put in place the policy measures to deliver these additional efforts, notably via the 'Fit for 55' package, with a revision of the EU emissions trading system (ETS), and the Effort Sharing Regulation that sets binding annual greenhouse gas emissions targets for Member States. In the area of energy, the EU has also set more ambitious targets for 2030. This implies that stronger progress is expected to be visible in 26 the coming years in the area of energy efficiency and renewable energies in the EU, as well. 51 Concerning life on land (SDG 15), even though terrestrial protected areas have increased since 2013, the EU continues to face steady declines in common bird and grassland butterfly populations. Additional efforts needed to reverse the degradation of ecosystems are envisaged in the EU 2030 Biodiversity Strategy, in the EU forest strategy for 2030 launched this year and in the EU Soil Strategy, which sets a 2030 objective on restoring degraded land and soil and combatting desertification. Regarding partnerships for the goals (SDG 17), the trend partially reflects cyclical effects and notably the increase in public debt resulting from the COVID-19 crisis.

Graph A2.1: **Implementation of EAR-relevant Country Specific Recommendations (CSRs)**



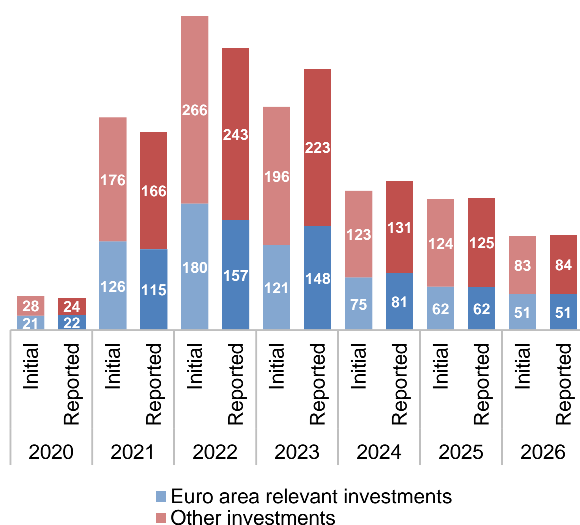
(1) Analysis at sub-CSR level. Sub-CSRs for 2019, 2020 and 2022 are grouped according to 2023 EARs.
Source: European Commission analysis based on CeSaR Database

The implementation of the 2023 euro area recommendations (EARs) can be assessed through the progress on the relevant country-specific recommendations (CSRs). Euro area recommendations are taken into account when addressing CSRs to euro area Member States in the context of the European Semester. The country recommendations are tagged as EAR-relevant when addressing challenges which are also important for the euro area as a whole. Accordingly, progress in the implementation of EAR-relevant CSRs of recent Semester cycles (2019 – 2022) provides an estimate of the degree of implementation of the EARs. As regards the 2023 EARs, the number of EAR-relevant sub-CSRs varies regarding different EARs, with a clear focus on green and digital transitions, as well as the labour market.

Overall, the implementation of EAR-relevant CSRs shows some progress, but the implementation varies across policy areas (Graph A2.1). While the CSRs related to fiscal policy (EAR 1) generally show a moderate progress, the measures linked in particular to sustainability of public finances (e.g. pension reforms) present a lower level of implementation. A relatively large number of CSRs address the EAR 2, on investment for the twin transitions and energy independence. Most of the sub-CSR relevant for EAR 2 show some progress in implementation (60% of sub-CSRs), while only 14% record “full implementation” or “substantial progress”. The progress in EAR 2 is to a large extent linked to the rollout of investment under the euro area Member States’ RPPs. Similarly, the CSR regarding reforms on labour market, including wages developments and social policy (EAR 3), show an overall good progress. However, reforms in those areas are generally slow and only 15% have recorded substantial progress over the last three years. Recommendation on corporate support (EAR 4) have been made in relatively fewer countries. However, they have generally been well implemented. These relate in general to liquidity support for companies, in particular small and medium-sized enterprises, and measures related to business environment. Relatively few sub-CSRs respond to the EAR 5 (the macro-financial stability, monitoring banking asset quality, non-performing loans, the completion of the Banking Union and work on the digital euro).

The implementation of the RRF is set to increase growth potential and contribute to income convergence in the euro area. The RRF's positive impact on the economy is expected to come both from higher investment, with crowd-in of private investment (Pfeiffer et al., 2023), as well as through the increase in productivity derived from structural reforms planned in the national recovery and resilience plans (Bankowski et al., 2022).

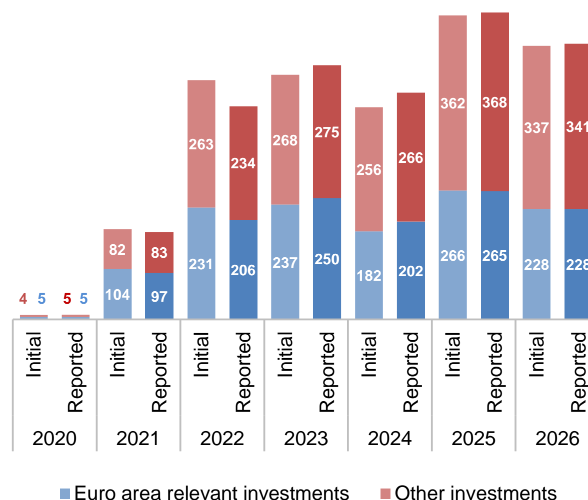
Graph A3.1: **Progress in reform milestones and targets in euro area RRPs**



(1) Numbers reported relate to the number of milestones and targets planned for a given year.
(2) The "initial" schedule corresponds to the content of the CID annex. The "current" schedule is based on bi-annual reporting by Member States. 2025 and 2026 are outside the scope of the reporting.
Source: European Commission

The implementation of national RRPs appears to be broadly on track. By mid-November 2023, the Commission has received 34 payment requests from 19 euro area Member States and disbursed a total amount of EUR 162.1 billion. This is around 40% of the RRF funds committed to the euro area Member States, with EUR 51.6 billion paid in pre-financing and EUR 110.5 billion of grants and loans paid after milestones and targets were reached]. Based on the Members States self-reporting, delays in investment and reforms are limited so far **(Graph A3.1** and **A3.2)**. Still, some Member States are facing challenges in administering funds, due, in part, to limited administrative capacity or investment bottlenecks (European Commission, 2023j). Revisions in RRPs, in particular to add REPowerEU chapters, may have delayed the disbursement schedule in some Member States.

Graph A3.2: **Progress in investment milestones and targets in euro area RRPs**



(1) Numbers reported relate to the number of milestones and targets planned for a given year.
(2) The "initial" schedule corresponds to the content of the CID annex. The "current" schedule is based on bi-annual reporting by Member States. 2025 and 2026 are outside the scope of the reporting.
Source: European Commission.

Investment and reforms included in recovery and resilience plans are set to contribute to euro area priorities. Mapping the various investments and reforms planned in the RRPs against the euro area recommendations of 2023 shows that about 40% of the milestones and targets corresponding to reforms planned over 2021-2026 respond to the EAR 2023 **(Graph A3.1)**. For investment, this ratio is close to 44% **(Graph A3.2**). More in detail, the various policy areas addressed in the EAR 2023 are covered in a heterogeneous manner. The EAR 1, on fiscal policy, is addressed through measures to increase quality and sustainability of public spending, in particular on healthcare and pension. EAR 2 on investment is extensively covered by the measures planned. Labour market reforms, which correspond to EAR 3, are addressed in particular through measures to improve active labour market policies, address skills shortages and promoting quality employment. By comparison, EAR 4 and 5, respectively on the business environment and on macro-financial stability, are less addressed in RRPs, although in some cases measures have been taken outside RRPs.

Table A4.1:**Main macroeconomic indicators of the euro area**

	2022			Annual percentage change						
	bn EUR Curr. prices	% GDP	04-19	2020	2021	2022	2023	2024	2025
GDP	13491.3	100.0	1.2	-6.1	5.9	3.4	**0.6**	**1.2**	**1.6**
Private Consumption	7062.5	52.3	1.0	-7.8	4.4	4.3	**0.6**	**1.2**	**1.5**
Public Consumption	2899.2	21.5	1.3	1.1	4.2	1.6	**0.2**	**1.0**	**0.9**
Gross fixed capital formation	3019.5	22.4	1.4	-6.2	3.8	2.6	**1.2**	**1.3**	**2.0**
Exports (goods and services)	7435.6	55.1	4.0	-9.0	11.2	7.2	**0.2**	**2.2**	**3.1**
Imports (goods and services)	7192.1	53.3	3.8	-8.6	9.0	7.9	**-0.3**	**2.3**	**3.0**
GNI (GDP deflator)	13529.5	100.3	1.3	-6.6	6.9	2.7	**0.5**	**1.3**	**1.4**
Contribution to GDP growth:	Domestic demand		1.1	-5.3	4.0	3.1	**0.6**	**1.1**	**1.4**
	Inventories		0.0	-0.3	0.7	0.3	**-0.3**	**0.0**	**0.0**
	Net exports		0.2	-0.5	1.3	-0.1	**0.3**	**0.0**	**0.2**
Employment			0.7	-1.4	1.4	2.3	**1.1**	**0.5**	**0.5**
Unemployment rate (a)			10.2	8.0	7.7	6.8	**6.6**	**6.6**	**6.4**
Compensation of employees / head			2.1	1.0	2.6	4.1	**5.5**	**4.5**	**3.4**
Unit labour costs whole economy			1.4	4.6	-0.2	3.4	**6.0**	**3.8**	**2.3**
Saving rate of households (b)			12.7	19.6	17.5	13.7	**14.5**	**14.5**	**14.4**
GDP deflator			1.4	1.8	2.2	4.6	**5.9**	**3.0**	**2.4**
Harmonised index of consumer prices			1.6	0.3	2.6	8.4	**5.6**	**3.2**	**2.2**
Terms of trade goods			-0.1	1.6	-3.2	-6.3	**4.4**	**0.2**	**0.2**
Trade balance (goods) (c)			2.0	3.3	2.7	0.2	**1.9**	**2.0**	**2.2**
Current-account balance (c)			1.7	2.3	3.6	1.0	**2.5**	**2.6**	**2.7**
General government balance (c)			-2.6	-7.1	-5.2	-3.6	**-3.2**	**-2.8**	**-2.7**
Structural budget balance (d)			-0.9	-3.7	-4.5	-4.0	**-3.2**	**-2.8**	**-2.8**
General government gross debt (c)			83.2	99.1	96.5	92.5	**90.4**	**89.7**	**89.5**

(a) as % of total labour force. (b) gross saving divided by adjusted gross disposable income. (c) as a % of GDP. (d) as a % of potential GDP.

Source: European Commission, autumn 2023 forecast

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